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Political economy of Islamic banking growth: Does political regime and institutions, governance and political risks matter?

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Abstract

This article explores the political economy of Islamic banking by examining the impact of political regime types, institutional environment, government and political risk on the development of Islamic banking proxied by financing or loan growth in the case of 16 Muslims majority countries with autocratic and democratic regimes over the period of 2000–2013. The performance of Islamic banking loan growth is examined from three different perspectives—political regime and institutions, governance and political risks in both regime settings. Results suggest that loan growth is positive and significant in democratic regimes where political and civil rights are predominant. In addition, loan growths are slower during election years but higher throughout pre-election year in democratic regimes, suggesting the opportunistic behaviour of incumbent government artificially boosting the economy in preparation for the upcoming election. It is also found that the good quality of public services, policy formulation and implementation, and credibility of government's commitment to realizing the policies are vital in ensuring positive loan growth. The lack of differences in the reaction of loan growth to the governance in democratic and autocratic regimes shows some convergence in the regimes despite having significantly different political perspective. This implies that political commitment of the ruling government is vital to set forth a strong and robust Islamic banking standing regardless of its political standpoint.

KEYWORDS

electoral politics, governance, institutions, Islamic banking, loan growth, political regime and political risk

1 | INTRODUCTION

The unprecedented growth of Islamic banking and finance in recent years has prompted financial services providers to expand their product portfolios towards Islamic law or *Shari'ah* compliant sphere to capture the demand for this growing market. Total *Shari'ah* compliant assets in the Islamic finance industry was reported as $2.5 trillion in 2018 (Thomson Reuters, 2019) compared to $861 billion in 2008 (Ernst & Young, 2009). The

statistics show that 70% the reported assets are with the Islamic banking sector (Thomson Reuters, 2019) indicating overwhelming importance of Islamic banking within the existing *shari'ah* compliant assets. Over the past four decades, Islamic banking has thriven in Muslim majority countries and currently advancing its footing in non-Muslim majority countries worldwide. As of 2018, approximately 44.9% of global assets in Islamic banks are in the GCC countries, while Malaysia's shares in global Islamic banking assets is 10.8% (IFSB, 2019).

The aftermath of repeated financial crises over the last two decades has unlocked the potential of Islamic banking as an alternative financing method and as a new financial breed for the overall financial architecture. With the growing number of world Muslim population, new Islamic banking and finance alternative is considered having essential growth potential. Even in a constitutionally secular state such as Turkey has in recent years intensified its effort in championing Islamic banking with plans to boost Islamic finance total assets to $100 billion by 2023 (Reuters, March 15, 2015). The Turkish government issued a $1.5 billion sovereign *sukuk* in 2012 and licenced two state banks (Vakif Katilim and Ziraat Katilim) to boost Islamic finance in Turkey in 2015, while Turkey's share in the global Islamic banking assets remains at 2.9% only. In Kuwait, loans growth in Islamic banking stands at 11.2% ($47.8 billion) compared to conventional banking with only 7.5% between January and September 2014 (Arab Times, 2015). According to the World Islamic Banking Competitiveness Report 2016 (Ernst & Young, 2016), in 2014, *Shari'ah* compliant loans and deposits account for almost 54% in Saudi Arabia, 33% in Bahrain, 54% in Kuwait, 25% in Qatar and exceed $100 billion in Malaysia and UAE.

This article extends the growing literature on Islamic finance from the political economy and institutional perspective. While there is an extensive empirical literature and practitioners' paper on Islamic banking, the impact of institutions and political economy on Islamic banking has relatively been underexplored. This general dearth of academic work on the impact of institutions on Islamic banking stands in contrast with the increasing importance that Islamic banking has in Muslim majority as well as in non-Muslim majority countries. This article, hence, aims to explore and examine the impact of political economy and institutional environment on the performance of banking generally and in Islamic banking, specifically proxied by financing, namely loans.[1] By comparing conventional banking and Islamic banking in Muslim majority countries with a different ontological base and political philosophy with its relevant settings, we aim to identify the role of political regimes and institutions, governance and political risk in different political spheres in the development of banking sector in general and Islamic banking in particular.

To initiate a broader debate on Islamic banking performance by probing into the role of political economy and governance in fostering the development of Islamic banking as proxied with loan growth, this papers is constructed on the argument that performance and growth in banking sector is an endogenous outcome generated by the type of regime, the quality of political institutions, political accountability and governance as part of public policy apart from the usual micro and macro determining variables. This leads to the hypothesis that better institutions lead to business-friendly policies, less red-tape, investor-friendly and less overall inefficiency, ultimately enhancing financial development in the country generally. It is important also to note that since Islamic banking products mirror their conventional counterparts, it is hypothesized that their reactions towards institutional and political variables would be the similar but relatively small size of Islamic banking as a whole may affect their reactions towards political variables.

This article is, therefore, developed around the following questions: If the political economy of institutions matter, does loan (financing) growth behaviour, as an indicator of Islamic banking performance, differ in the different political regime and political institutions? To explore and examine this research question, this article compares the behaviour of loan growth of Islamic banks in both democratic and autocratic regimes, and, in comparison, with the conventional banks. The performance of Islamic banks measured in terms of financing or loan growth is examined from three different political economy frames—polity, governance and political risks in both regime types. Financing or loan growth is selected because it indicates growing businesses as a result of favourable business environment propelled by proper institutional management.

A sample of 16 majority Muslims countries with autocratic and democratic regimes is selected to examine this case over the period 2000–2013. The sample of Muslim dominated countries led by democracies includes Turkey, Malaysia, Indonesia, Pakistan and Bangladesh, while autocratic regime is represented by the GCC countries, Sudan, Egypt, Yemen, Iran and Jordan.

Although the autocratic regime-based countries have greater Islamic banking total assets as can be seen in Figure 1, the data suggest that loan growth is higher in democratic regimes compared to autocratic regimes. Overall, we find that regardless of political regime type, the reaction of loan growth towards political variables does not significantly differ, which could be possible due to the impact of international financial integration which eliminates these differences. The findings also suggest that both institutionalization and competitiveness of

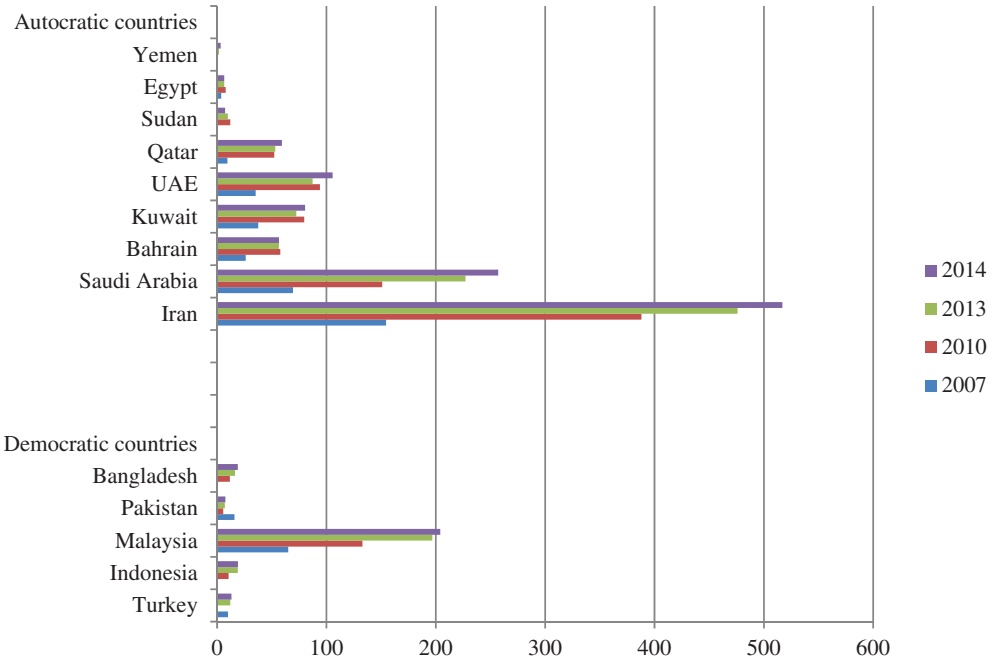

FIGURE 1 Growth of *shari'ah* compliant assets USD (billion). *Source*: The Banker (2013, 2014) [Colour figure can be viewed at wileyonlinelibrary.com]

executive selection play essential roles since the framework set by them would affect loan growth. However, frequent changes in executive may result in policy change which is not an ideal situation in promoting loan growth. Therefore, all election dummy variables are found to have a negative impact on loan growth. In the Islamic banks in democratic countries sub-sample, the results demonstrate that loan growth is higher a year before the election, indicating incumbent government's attempt to artificially boost the economy as part of political business cycles. Similarly, having loan growth being slower during election period implies uncertainty of the outcome of the election with investors using the 'wait-and-see' strategy (Bjerksund & Ekern, 1990). In general, the findings demonstrate that governance plays an important role in loan growth, as all governance variables are significant in the overall sample. For example, corruption is statistically negative and significant in all cases except for Islamic banks in autocratic sub-sample suggesting higher corruption may decelerate loan growth. In addition, in the case of Islamic banks in autocratic regimes, corruption has a positive impact on loan growth suggesting bribery and other forms of corruptions expedite business processes by reducing waiting time for approval and bypassing stringent rules and requirements. Furthermore, regulatory quality and voice and accountability is found to be negative and significant in all the Islamic banks sub-sample but are positive for the whole sample implying specific conventional framework being suitable for the development of conventional banking but may retard development in Islamic banking. The length of government tenure is consistently statistically negative in the whole sample and two sub-samples indicating that durability of a particular party or monarchy may impede the adoption of new technologies and ideas especially in banking, which, in turn, slows down loan growth. Finally, results depict that political risks variables impacted loan growth differently across the samples. In the overall sample, government stability, internal conflict, law and order and democratic accountability significantly affect loan growth. In the case of Islamic banks in democratic regimes, better socioeconomic conditions and lower internal conflict provides a favourable environment for better loan growth. Corruption and law and order in the autocratic regime have a negative impact on loan growth implying that some amount of corruption and lax law and order positively affect loan growth by accelerating and evading bureaucracy, requirements and cumbersome rules and regulations.

The remainder of the article is organized as follows: the next section reviews some of the recent developments in Islamic banking along with identifying the identified principles of Islamic finance. Section 3 aims to present the theoretical framework of this article in the form of political economy and institutional economics. It also discusses the articulation of theoretical frames in the form of empirical studies to render a base for the variable selection. This section also highlights the differences and recent development in Islamic banking in both democratic and authoritarian regimes whereby the hypotheses are constituted. Section 4 presents the variable definition in line with the theoretical framework along with empirical modelling. Empirical analysis and findings are presented in Section 5. The final section presents the conclusions.

2 | ISLAMIC FINANCE AND BANKING

Islamic banking emerged to respond to religiously motivated financial inclusion by providing *Shari'ah* or Islamic law compliant financing and banking model for Muslims as an alternative to the interest or *riba*-based system in the conventional banking. Given the paradigm shifts of Muslim legalists, methods such as *hiyal* (ruses) have been used to get around the theoretical prohibition of *riba'* resulting in the expansion of financialization through reverse engineering method. As a practice, hence, Islamic banking and finance complement existing conventional banking offering products that are within the parameters of the *Shari'ah*.

The basic *Shari'ah* tenets in relation to Islamic finance, as part of negative screening, include non-engagement in interest-related transactions, no financing in non-*Shari'ah* compliant businesses, no investment in non-*Shari'ah* compliant companies, bonds, stocks and equities, while it promotes profit-loss sharing and risk-sharing business models by prohibiting speculative and non-asset-based transactions.

Despite their contrasting philosophical difference, Islamic banks are arguably similar to conventional banking in terms of their operational mechanism (Beck et al., 2013) except for *Shari'ah* compliance, have no significant advantages in efficiency and stability, pro-cyclical, having profit rate higher than the conventional rates and compete in the same market as other conventional banking, since the products of Islamic banking are basically replications of the existing conventional products with *Shari'ah* compliance. Although profit sharing is notably the business models that fulfil the *maqasid al-Shari'ah* or the moral objective of Islamic law, fixed income structures, such as *murabahah* and *tawarruq*,[2] are more successful and constitute large part of total Islamic banking financing.

Except for Iran and Sudan, Islamic banking and finance is practised as a dual banking within the existing (conventional) financial system in the world either as a full-fledged banking sector or as Islamic windows. *Shari'ah* compliant assets have grown considerably over the years despite the total *Shari'ah* compliant asset accounting only 1.5% of the total global banking assets (The Banker, 2017). Figure 1 shows the total *Shari'ah* compliant assets over 2007–2014 with Islamic banks in the autocratic regimes having three times bigger than the share of the total assets. Iran has the most considerable Islamic banking total assets, as the law and legal framework does not permit the existence of conventional banking system.

In recent years, Islamic finance has permeated into non-majority Muslim countries such as the USA, the UK, Singapore and European countries and especially Luxembourg. This positive development is attributed to two primary reasons. First, the Muslims population in these countries and regions has increased. In Europe, the Muslim population is around 44 million in 2010, 3.3 million in the UK or 5.2% of total UK population in 2013 and 6.67 million or 2.11% of total population in the USA. Second, to tap into the accumulated wealth emerged due to petrodollars in the GCC region, *Shari'ah* compliant investment avenues are considered as an important strategy by this non-Muslim majority countries. Singapore, the UK and Luxembourg, among others, for example, have gone to a great extent by providing *Shari'ah* compliant structures and products, amending rules to accommodate Islamic finance and providing *Shari'ah* compliant investment avenues in the quest to becoming the Islamic financial hub in the respective regions. Third, the growth of Islamic finance is fuelled by the consumers' demand for *Shari'ah* compliant assets by Muslims living in non-Muslim majority countries.

Table 1 provides the demographic description of the countries from which the sampled Islamic and conventional banks were drawn. Among the countries with a democratic regime, Malaysia has the highest share of Islamic banking assets, although Muslim population is only approximately 63.7% of the total population compared to Indonesia, Turkey, Bangladesh and Pakistan with 87–98% of Muslim population. While Malaysia ranks lowest Muslim populated country in the group, but Islamic banking has made important inroads becoming a serious alternative with a significant share in the financial system. Nevertheless, having a large number of Muslims in Turkey, Indonesia and Pakistan indicate a potentially significant market for Islamic finance in general despite emerging and niche Islamic banking sector in these countries. Among the autocratic regime, the majority of countries in our sample have more than 90% Muslim population indicating a sizeable potential market that has yet to be tapped. Under such circumstance, it is important to understand the role of political institutions in driving the development and progress of Islamic finance generally and Islamic banking, specifically.

3 | THEORETICAL FRAMEWORK: POLITICAL ECONOMY, PUBLIC CHOICE, INSTITUTIONAL ECONOMICS AND REGULATION SCHOOL

A number of approaches emerged since the 1960s to expand the explanatory power of neo-classical economic analysis in the face of the observed weakness in its constructs, each of which aimed to render an additional

TABLE 1 Demographic description: Islamic banking assets

Country	Shari'ah compliant assets (USD million)	Muslim population	% Muslim population
Democratic regime			
Malaysia	204,139	18,929,707	63.7
Indonesia	19,101	217,882,830	87.2
Bangladesh	18,974	140,622,276	89.8
Turkey	13,063	73,433,988	98.0
Pakistan	7,622	175,585,461	96.4
Autocratic regime			
Iran	516,976	77,214,826	99.7
Saudi Arabia	257,054	26,810,849	93.0
UAE	105,780	7,187,173	76.9
Kuwait	80,425	2,496,112	74.1
Qatar	59,254	1,468,192	67.7
Bahrain	56,593	936,516	70.3
Sudan	7,429	34,433,626	90.7
Egypt	6,532	77,871,503	94.9
Yemen	3,308	24,187,715	99.1
Jordan	1,880	6,016,680	97.2

Note: Compilled with data from The Banker (2013, 2014).

strength by bringing omitted paradigms into the theory and the modelling of neo-classical economics. Such approaches, among others, including within the larger political economy umbrella, public choice, institutional economics, economic sociology and regulation school. Their main argument is that economic and financial actions, events and policies must be located within the larger environment by recognizing that politics, political institutions, sociological institutions and regulations have an impact on their emergence, performance and evolvement. As it is argued that unlike the simplified version of economic interaction (between households and firms) provided by traditional neo-classical analysis, political economy through its various institutions and in particular through politics and political institutions determine the functioning of economy and finance. Therefore, in particular (new) political economy, public choice, institutional economics and regulation school attempted to expand the economic analysis through recognizing the role of such institutions since the 1980s. The emergence of Islamic economics and finance movement coincides with the same concern and therefore emerged in the same years in 1960s and received global recognitions since the 1980s to essentialize the importance of religion on individual and organizational behaviour (Asutay, 2007b, 2013).

Political economy can literally be defined as 'the complexity of interaction between political and economic behaviour' (Borooah, 1985, p. 20). In a formal sense, 'political economy studies the interdependence between the economy and the polity of a country or countries' (Frey, 1978, p. vii; Frohlich & Oppenheimer, 1978). In referring to the endogenizing politics and institutions into economic analysis to develop a more effective analysis, Caporaso and Levine (1992, p. 31) rationalizes political economy on the ground that 'political and economic processes and institutions are interlinked and should be studied as a complex and interrelated whole rather than as separate spheres'. Therefore, public choice theory within the new political economy entirely focused on political and economic interaction to understand the economic performance of countries, organizations and individual economic and political behaviour (Mueller, 1989). For example, political business cycle theories explore the political manipulation of the economy for electoral purpose whereby the change in the business cycles is considered as an outcome of rational politicians aiming to be re-elected (Alesinaet al., 1997).

Institutional economics (*see*: Acemoglu, 2008; North, 1990) and Regulation School (*see*: Aglietta, 1976; Boyer, 1990; Boyer & Saillard, 2002) has articulated such a political economy concerns and brought the institutional and regulative as well as governance quality to the analysis in an attempt to provide an integrated and complete analysis. As part of the institutional economics, religion is considered as an important institution determining individual and economic performance

(Barro & McCleary, 2003; Guiso, Sapienza, & Zingales, 2003; Iyer, 2010; Kuran, 2004, 2018).

In line with such developments, as discussed in the preceding section, while Islamic economics brought the normative values of Islam into economic understanding (Asutay, 2007a, 2007b) since the 1960s, Islamic finance has produced *Shari'ah* compliant financial products and solutions since mid-1970s (*see*: Asutay, 2015; Ayub, 2007).

This article, thus, is located within the larger political economy theoretical framework as expressed through public choice, institutional economics and regulation approach. The subject matter of the article is the performance of Islamic banking which is Islamically determined or *Shari'ah* compliant institutional form of financing in the sense how the frames (political regimes, governance quality and political risks) developed from these theories have affected the performance of Islamic banks. Thus, Islamic banking performance is examined within the interaction of politics, institutions and governance as suggested by the theoretical framework of political economy. The following sections discuss the articulations of these theoretical frames and relevant empirical research in order to develop an effective set of variables for this empirical study.

3.1 | Political and economic interaction

The mainstream economic models view democratic institutions at its best, generate economic growth (Barro, 1989; North, 1990), while state autonomy is pernicious, the source of inefficiency, impedes growth and development (North, 1990). Among others, Baum and Lake (2003) suggest democracy is an effective tool to ensure maximum economic freedom, efficient use of resources, and safeguard the private sphere for the proper functioning of the market, which later, trickle down as growth.

The empirical impact of the polity on the economy has been relatively well documented; however, studies show mixed results. Przeworski (1966), Huntington and Dominguez (1975), Weede (1983), Landau (1986), for example, shows autocratic regimes demonstrates higher economic growth levels. On the contrary, Dick (1974), Pourgerami (1988, 1991), Barro (1989) and Feng (1997), amongst others, show that democracy fairs better regarding growth. Kohli (1986) and Marsh (1988) show no difference between the two regimes. In assessing these two institutional frameworks, Butkiewicz and Yanikkaya (2006) found that democracy has a negligible impact on growth, and Helliwell (1992), Tavares and Wacziarg (2001) and Aisen and Jose Veiga (2013) suggest that democracy has a negative impact on growth. They argued that democracy hinder growth since physical capital accumulation is reduced via increased government consumption spending. Jetter (2014) demonstrate that volatility of government spending has an adverse effect on growth in democratic regimes but positively affect growth in autocratic regimes since in autocratic regimes the public has limited political involvement, triggering little or no effect to government spending. In democratic regimes where public voice is one of the determining factors of government spending, increase in volatility leads to lower growth. Chen and Liu (2013) show that during election years in Taiwan, private financial institutions have higher loan growth and return on assets. There is also empirical consensus that political instability can adversely affect a wide range of macroeconomic variables such GDP growth (Aisen & Jose Veiga, 2013; Alesina et al., 1996; Jong-a-Pin, 2009), private and public investment (Alesina & Perotti, 1996; Darby, Li, & Muscatelli, 2004) and government spending (Devereux & Wen, 1998) by disrupting long-term economic policies.

Importantly, democracy is often argued to be inherently stable due to its predictability, as political stability is vital due to extending policymakers' horizon leading to optimal policies although Public Choice school's scepticism as to how democracy is used to manipulate the economy leading to welfare losses. In addition, democracy provides transparent rules, which reduce the incentive of ruling government to implement predatory political decisions on the private resources of the economy. In a democratic system, which encourages open debate and open public policy decision making, policy extremism and power taking via illegitimate means can be well avoided. Furthermore, it is argued that democracy reduces policy disequilibrium and is knowledge-induced because the outcome and policy consequences pre and post elections, the aftermath policies and consequences can be well predicted and hence, can be hedged (Freeman, Hays, & Stix, 2000; Feng, 1997). The existence of elections within democratic polity allows more peaceful and predictable transfers of governing parties, thus, reducing volatility in policies. It can, therefore, be concluded that given macro-political stability and ability to make micro-political adjustment existed in democratic settings; the economy can grow faster leading to loan and deposit growth in banks.

Within the macro-political settings, institution is considered vital to financial development and growth; and therefore, improvements in the political, legal and economic institutional environment are evidenced to having positive effects in promoting financial growth (Beck et al., 2003; Huang, 2010; Rajan & Zingales, 2003). For the efficient institutional environment, democratic regime is considered as a priori fostering an open society,

encouraging fundamental civil liberties and providing a politically stable environment for businesses to prosper. With democracies, protection of property rights and contract enforcement are facilitated which is the key to investment growth (Acemoglu, Johnson, & Robinson, 2005; Clague et al., 1996; Olson, 1993). Moreover, it is evidenced that under democracy, corruption is suppressed with proper implementation of law and order leading to increased efficiency of institutions. Therefore, for the financial market to function efficiently, a robust and inclusive legal and regulatory framework must be present as provided by democracy; as law and order allow for the financial market to operate efficiently with all disputes settled within the legal framework.

The quality of governance is expected to be superior in democratic regimes as compared to autocratic regimes. The inclusive political process ensures politicians being subjected to regular public scrutiny and checks by the opposition parties, therefore, minimizing power abuses, distortionary policies that only benefit a small section of the population and control the quality of policymaking. Civil engagement in democratic regimes should promote citizen participation in public policies such that special attention could be given to marginalized groups to ensure financial inclusiveness or access to banking and other financial services. Therefore, banking and financial services are available for businesses, individuals and even for the majority poor in effective democracies. The existence of a prudent legal framework is vital in ensuring the efficacy of contract enforcement, treatment to creditors and shareholders, and sound accounting practices. In democracies, regulation and enforcement is the result of a balance between social and economic constituencies (*see*: Gimma & Shortland, 2008; LaPorta et al., 1997; Pagano & Volpin, 2001). Mauro (1995) suggests that bureaucratic performance such as the level of corruption, independence and effectiveness of the judicial system and red-tapes affects economic growth, which essentializes the facilitatory setting of democracies.

In the case of an autocratic regime, many economic decisions are driven to protect the interest of the elite groups due to restrictions in the participation of type of political system based on patronage. The autocratic regime is thought to impede financial development due to lack of suffrage in politics, the heavy influence of elite group over policy and decision making, lack of property rights laws and lack of implementation of law and order.

Arguably, elections and polls in democratic regimes may give rise to uncertainty. In the presence of two contrasting competing parties, the outcome of elections may result in the dissolution of the current ruling party and replaced by its opposition. If their policy direction changes starkly, bankers may need to revise or revamp their current strategies to assimilate with the overturned situation. In this case, bankers cannot effectively gather enough information or may fail to hedge against the unexpected changes. Consequently, loan, assets and deposit growth may be affected in a downward manner. Due to these unexpected political events, bankers need to reformulate their decision and strategies. In addition, democracies may not necessarily exhibit smooth political transition; as elections and constitutional democracy can be superseded by military coup *d'etat* as in many developing countries, such as Bangladesh (in 1975, 1981, 2007 and 2011), Pakistan (in 1969, 1977 and 1999) and Turkey (in 1960, 1971, 1980 and 1997).

Democracy, on the other hand, does not always equate to stability. The in-built feature of democracy which promotes public participation could create a number of pressure groups, which may lead to inefficiency in economic decision making. Ruling parties wanting to preserve their seats in the next election tend to submit to pressures from these groups at the expense of the general public interests. If lower income groups dominate the ruling party, political power can be used to raise wages along with redistributive policies which impede investment and consequently, growth. Countries in a transition from autocracy to democracy may experience internal conflict, ethnic problems leading to political instability, economic disorder and consequently, slower economic and financial growth. Some pressure groups especially the incumbent firms and government-linked companies (GLCs) can directly influence the ruling party to make decisions in favour of them despite being in a democratic regime.

A competing line of argument holds that autocracies create political stability in general since long-term policies can be carried out without many political distortions. The absence of government dissolution and reformation of new ruling government, switches between competing political parties, which potentially produce unpredictable events and policies changes, can be easily avoided. Banking and financial sector can fully anticipate current and future political events, since the ruling government is less prone to policy swings, and incorporate this information in their investment decisions, marketing strategy and future directions of the banks. Stability in the political system is expected to promote overall growth and development of the Islamic banking system.

The second distinct feature of authoritarianism is its capacity to insulate and control the effects of pressure from influential firms and unions. Individual firms' objectives are often suboptimal, short-term and specific to their firms, unions or production, which consequently lead to underinvestment, un-optimal use of resources and less efficient production. In an autocratic regime, the

state is free from distributive pressures emanating from the public, which facilitates implementation of growth-enhancing measures. State autonomy promotes economic growth via institutions, education, increasing returns to scale and allocative efficiency (*see*: Haggard, 1990; Przeworski & Limongi, 1993; Wade, 1990), since political autonomy permits the state to extract resources efficiently, provide public goods, and incurs necessary short-term costs to facilitate economic adjustments and other growth-related policies.

In an autocratic setting, the role of public opinion in influencing banking policies is limited by definition. The absence of a channel through which public can express their desired level of banking services is expected to lower growth rates of the banking system in autocratic regimes. Many autocratic regimes experience violent and erratic political transitions. Examples from the developing world include Egypt in 2011 and 2013, Iran in 1921, 1953 and 1980, Sudan in 1958, 1969, 1985 and 1989, and Yemen in 1962 and 1974. Political turmoil arising from military coups and hostile takeover exert harmful effects on growth.

Acemoglu (2008) further argues that oligarchies fail to take advantage of new growth opportunities due to the erection of barriers to entry especially entry of new entrepreneurs and new technology, which later, undermines growth potential. In his theoretical exposition, Acemoglu (2008) shows that oligarchies protect the property rights of the producers and prevent distortionary taxes, which in turn enable politically powerful elite groups to monopolise. In contrast, democracy promotes a more egalitarian distribution of resources by suppressing the power of incumbent elites. On the other hand, an oligarchic government may have pro-business policies, which spur the economy to unprecedented growth; South Korea and Japan in the 1960s are the 'living proof' of this intuition.

As more countries in the world are aiming to consolidate their democracy, we also witness the elements of autocracy within a democratic setting especially when the ruling party has more than two-thirds majority, such as Malaysia (1955–2004) and Singapore (1959–2011). Democratic rulers have the incentive to increase the sphere of governmental activities to maximize their leverage over the economy and to ensure the durability of their tenures. The elements of property rights as championed under democracy is further enhanced with not only property rights ensured to politically linked conglomerates, but also secured internal market (*see*: Acemoglu, 2008). Autocratic elements within a democratic structure can be seen via the existence of elite groups. These elite groups are primarily related to the ruling government via political and non-political ties, cronies of the top officials and groups of individuals financially assist them during previous elections. In this case, an electoral democracy assimilates features of autocracy when a group of elites control the parties or the electoral agenda. Elites groups, which control a significant proportion of the economy, may exist in a democratic system, who normally have strong back-up from the government. Government support towards these elite comes in the form of costly private sector projects backed by a government, GLCs, 'letters of support' or 'unwritten guarantees' which has legal implications. These elite groups will later finance electoral campaigns and other activities to secure tenure-ship of the ruling party. The existence of these elite groups is more evident during bailout exercises in the aftermath of a crisis. Therefore, despite having substantially different philosophic foundations, democratic and autocratic rulers may express themselves in the same manner in policy making and distribution of resources.

It is sometimes hard to relate political regimes with economic or financial development. Autocratic regimes have different economic objectives and policies, which can later impact their economies differently (*see*: De Long & Shleifer, 1993; Jones & Olken, 2008; Larssons & Parente, 2013). As such, it is sometimes argued that the objectives of the government are the main determining factors towards economic and financial growth, rather than which political regime they choose to reign. Reasons for this include democracy having a comprehensive concept (Persson and Tabellini, 2006) and the distinction between democratization and economic and financial liberalization.

Financial liberalization is vital in the case of banking if such liberalization includes granting of new banking licenses, encouraging foreign banks to enter the domestic market, more investor-friendly rules and regulation. This might require some control over the economy; and therefore, economic and financial liberalization in developing countries mainly took place under autocratic regimes (see the cases with Argentine, Turkey, Indonesia, among others). On the other hand, Aidt et al. (2008) and, to some extent, Flachaire et al. (2014) suggest that institutions that shape the policy framework and implantation of those policies, corroborating the relevance of the autocratic versus democratic regime debate.

On theoretical grounds in institutional economics, corruption is dreaded, since it distorts the market economy and the efficient running of the financial system resulting in reduced efficiency of government and businesses since corruption allows certain elite members to gain businesses through patronage rather than ability. Bribes or special payments make the cost of running business higher and consequently; the investment may

be held back. In contrast, some businesses are willing to pay bribes to expedite the business procedure if the cost of the bribe can be offset by the profits gained. In this case, corruption has a positive effect on the economy, as evidenced by the empirical support offered by Mauro (1995).

3.2 | Political-institutional environment and banking sector nexus

As regards to the impact of political institutions and their nature on financial and banking sector, this can be viewed from several perspectives. It is argued that governments can significantly impact the financial activities not only via policies but through indirect political influences on major financial institutions especially government-linked financial institutions or politically connected individuals hold important decision-making positions in the financial institutions. Government-owned banks, for example, may channel funds to politically motivated projects while disregarding public interest (Baum et al., 2010; Chen & Liu, 2013).

The political channel is expected to be stronger in countries with democratically elected members. During election years, for example, bank lending is expected to increase substantially through supply shock or demand shock channels. If bank lending which leads to increase on loan growth is accompanied by a decrease in the cost of lending, then we hypothesize that lending is driven by supply shocks or what is termed as 'political lending' (Micco et al., 2007). On the other hand, demand shock is where bank lending is associated with an increase in the price of the loan. From a political economy perspective, banks may increase their lending to state-owned enterprise or to firms with politically connected directors (Khwaja & Mian, 2005; Sapienza, 2004) in an attempt to garner more support from the corporate sector for the elections for favourable returns. On the contrary, autocratic leaders may impose their will on banks especially state banks to achieve specific political or economic goals (*see* among others, Gabgub, 2007 on the impact of Libyan government on bank lending).

The work by Dinc (2005), Micco et al. (2007), Sapienza (2004) and Khwaja and Mian (2005) provide empirical evidence where state banks increase loans during election years, whose findings are robust across different time period and sample sizes. Sapienza (2004) and Khwaja and Mian (2005) studies Italian and Pakistani banks, respectively, while Dinc (2005) and Micco et al. (2007) extended the study to a more extensive set of countries. Micco et al. (2007) deduce that increased lending behaviour during election years are not affected by different regions and that such behaviour is indifferent regardless of being in a democratic or autocratic regime. Cole's (2009) study on India shows that bank credit is 5–10% higher in election years, especially in districts, which are heavily contested. On the contrary, in examining a sample of commercial, foreign and state banks from Turkey for the period of 1967 to 2007, Baum et al. (2010) found that elections have significant effects on bank behaviour in the form of loan growth, deposit growth and bond growth but they could not find evidence for elections leading to higher lending rate whether the banks are state-owned, domestic or foreign-owned banks. Similarly, Onder and Ozyildirm (2013) in their study covering 67 (1992) to 81 (2000) provinces between 1990 to 2010, conclude that state-owned banks give credit for political reasons during election years as results from their study show that the share of state-owned banks in Turkey during crisis and election years are significantly higher. Chen and Liu (2013) found that private banks earn higher ROA and loan growth during election years compared to foreign-owned banks in Taiwan from 1994 to 2009. At the same time, government-owned institutions lending were no longer affected by political pressures denoting the success of financial reforms undertaken by the Taiwanese government in 2002.

Bongini et al. (2002) show how government intervention motivated by political connections help to rescue deteriorating banks. Unqualified borrowers with political connections get to borrow from state-owned banks or banks whose shareholders have political connections (Fraser et al., 2006; Khwaja & Mian, 2005). A study in Ukraine by Baum et al. (2008) suggest that interest rate margin is much lower in politically affiliated banks. On a similar note, state-owned banks tend to charge lower interest rates in areas where these banks have a strong affiliation with the political party, which won the election (Sapienza, 2004). In similar veins, Jackowicz et al. (2013) argue that the net interest margin during election years is lower due to politically motivated policies. In their study, which covers banks in Central Europe, lower net interest margin is the outcome of a lower interest rate on loans. In examining the impact of political uncertainty, Flachaire et al. (2014) found that greater political uncertainty is associated with higher cost of loans: the estimated increase in interest spread is 11.90 basis point for one standard deviation increase in idiosyncratic political exposure.

A more recent study by Hernandez and Vadlamannati (2016) shows Saudi Arabia's political influence on the Islamic Development Bank favouring the *Sunni*-school following Muslim states *vis-à-vis* the *Shia* majority states when giving out loans.

Eichler and Sobanski (2016) show that electoral cycle, the ideology of the government party and the power of the government significantly affect the stability of banks in the Eurozone. Specifically, government tenure, government majority in parliament, government fractionalization and left to right party preference positively and significantly affect bank stability. Their study also suggests that smaller banks are more subjected to national politics compared to larger banks which are highly capitalized which makes them unaffected by risky political environment. In the case of the UK, Kleymenova et al. (2016) show that after nationalization, non-British banks increased their external funding and locate their lending away from the UK in the sample of 334 banks in the UK from 1999Q1 to 2011Q4. Ashraf (2017) shows that political and legal institutions affect banks risk-taking behaviour. In a sample of 98 countries ranging from 1998 to 2007, he shows how healthy political institutions boost credit market competition due to increased risk-taking behaviour but would generate moral hazard problems since there is some assurance for the government bailout in the case of default.

3.3 | Islamic banking and political economy interaction: Hypothesis development

While the initial discourse of Islamic economics suggested an economic system generated through the ontological base of Islam and its value system and normative principles (Asutay, 2007a, 2007b, 2012), due to the global political economy this was not possible (Elashker & Wilson, 2006). Hence, Islamic banks have been operating within the existing political and economic system as hybrid institutions providing hybrid products. In other words, except for Iran and Sudan, Islamic banking has been operating within the dual banking system under the impact of the existing political regimes and institutions and mostly under the existing banking law and regulations. While Iran and Sudan provide Islamic political environment for the operation of Islamic banks, in recent years several countries, led by Malaysia, issued special law and regulation for the efficient operation of Islamic banks. However, Islamic banking laws and regulations still essentialize the neo-liberal economy and financial environment (Rudnyckyj, 2013, 2014) rather than developing an alternative system. Therefore, within the hegemony of the existing financial system, Islamic banks must comply with Basel rules in order to be competitive. In a similar way, the corporate governance of Islamic banking institutions is determined by the existing financial system and the political regimes (Rethel, 2010, 2011) and therefore rather than Islamic governance of extended stakeholding, shareholder value maximization determines the operational nature of corporate governance in Islamic banking.

While AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institution) and IFSB (Islamic Financial Services Board), as the two main standard setters for the industry, have issued a number of standards in relation to the operation and the governance of Islamic banks (Asutay, 2015), such standards still remain within the frames of the existing financial system rather than disrupting them. Therefore, as mentioned above, Islamic banks represent hybrid institutions with their hybrid products (Asutay, 2012) to ensure efficiency and competition in the dual banking system by using Islamic norms in the form of *Shari'ah* compliance.

Based on the existing literature discussed so far in the preceding sections, political and institutional factors as the articulation political regimes seem to have some impact on the banking system and the performance of banks. However, due to being hybrid institutions within the capitalist economy, Islamic banks are expected to be affected by the same political and institutional factors. However, research on how the political system and their respective institutional environment affect Islamic banking is almost absent except for Bitar et al. (2017). In their study, Bitar et al. (2017) aim at examining the impact of democratic and non-democratic political environment and also the impact of legal systems (*Shari'ah* based, hybrid and Western) on the financial soundness of Islamic banks. They conclude that compared to the financial soundness of conventional banks, Islamic banks underperformed in the democratic political environment, while performed better than conventional banks in hybrid and *Shari'ah* based legal system.

This article intends to fill the observed gap in the literature by presenting an extended analysis using different proxies to capture the effects of political regime and political risk as well as governance quality on Islamic banks and conventional banks in the sampled countries in a comparative manner. To operationalize the research, in light of the discussion provided so far, the following hypotheses are developed:

H1 Democratic regimes (in various forms) have a positive impact on financing/loan extended by Islamic banks.

H2 In democratic countries, elections have a positive impact on financing/loan extended by Islamic banks.

H3 Quality of political governance has a positive impact on the financing/loan extended by Islamic banks.

H4 Political risks have a detrimental impact on the financing/loan extended by Islamic banks.

The political and institutional constituents of these hypotheses are discussed in detail in the following sections to demonstrate the choice of representative and appropriate variables as listed in Table A2.

4 | VARIABLE DEFINITION, SAMPLE AND ECONOMETRIC SPECIFICATIONS

4.1 | Variable selection and definition

Based on the theoretical framework and its articulation presented in Section 3 as well as the discussed empirical literature, three sets of institutional variables were considered to examine the impact on loan or financing growth in Islamic banking in the dual banking system with the additional of Islamic banks in the Islamised economies of Iran and Sudan. These are political regime, governance quality and political risk. Political regime related variables refer to Hypothesis H1 and Hypothesis H2, governance quality related variables aim to test Hypothesis H2 and Hypothesis H3 is tested by political risk factor. By considering these variables, political economy theoretical framework's aim of endogenizing the impact of politics and institutions is endogenized in the study. The following section presents the selection and definition of these variables to provide a further rationale, while a summary of variable definitions and sources of data is provided in Table A2.

First, political regimes and their features are captured using two databases: Policy IV and Freedom House. Polity IV variables consist of the degree of democracy (*demo*) and autocracy (*auto*). In the case for a democratic regime, six polity component variables and three concept variables are included. The extent of institutionalization of executive transfer (*xrreg*), the competitiveness of executive selection (*xrcomp*), the openness of executive recruitment (*xopen*), executive constraint (*xconst*), degree of organization and institutionalization of selection (*parreg*) and degree to which political participation is free from government control (*parcomp*) represent the polity component variables; executive recruitment (*exrec*), executive constraint (*exconst*) and political competition (*polcomp*) capture the concept variables. These variables include factors ranging from the degree of competitiveness of political participation to the degree of constraints on chief executive. The concept variables provide an alternative approach towards understanding polities of the authorities since there are various paths to democracy and autocracy. The election years were obtained from Database of Political Institutions (DPI).

An alternative proxy for the political regime is the database provided by Freedom House, which is divided into two major categories political rights (*pr*) and civil liberties (*cl*). The combination of these variables determines whether a country is free, partly free or not free. Political rights (*pr*) have three major components: electoral process (*a*), political pluralism and participation (*b*) and functioning of the government (*c*). Civil liberties (*cl)* capture the freedom of expression and believe (*d*), associational and organizational rights (*e*), the rule of law (*f*) and personal autonomy and individual rights (*g*). The use of these three different databases allows us to capture different aspects of political regimes. In overall, the Polity IV database captures details of the inside mechanism within the institutions, while the Freedom House database assesses the overall running of the political institutions.

The second part of the institutional variable is governance. The World Governance Index (WGI) issued by the World Bank provides seven measures to capture the efficacy of governance worldwide: control of corruption (*cor*), government effectiveness (*g_eff*), political stability and absence of violence and terrorism (*p_stab*), regulatory quality (*reg*), rule of law (*rol*), voice and accountability (*voa*) and tenure (*ten*). Control of corruption (*cor*) examines to what extent public power is exercised for the private gain of elites and private interests. Government effectiveness (*g_eff*) describes the quality of public and civil services, independence from political pressures, policy formulation and implementation and government's commitment towards realizing the policies. Political stability and absence of violence (*p_stab*) captures the possibility of overthrowing governments in an unconstitutional manner. Voice and accountability (*va*) shows freedom of expression, freedom of association, free media and ability to participate in the selection of government freely. The rule of law (*rol*) captures the extent of contract enforcement, property rights, the likelihood of crime and violence and how much confidence agents have in abiding the rules of the society. Finally, regulatory framework (*reg*) summarizes the ability of the government to formulate and implement sound policies and regulations that will enhance private sector development. In short, the process by which government are selected, monitored and replaced are represented by voice and accountability (*va)* and political stability (*p_stab*). The efficacy of government policy formulation and implementation is captured by government effectiveness

(*g_eff*), and regulatory quality (*reg*) and the confidence of the people towards the state is indicated by the rule of law (*rol*) and control of corruption (*cor*).

The third part of the institutional variable is the political risk. Data is obtained from the International Country Risk Guide (ICRG), from the PRS group. We use six sub-components of the ICRG political risk measures: government stability (*g_stab*), socioeconomic conditions (*socio*), internal conflict (*int_con*), democratic accountability (*dem_acc*), corruption (*cor2*) and law and order (*lao*). Only 6 out of 12 measures were selected owing to their applicability to the countries in our sample. Among these, government stability (*g_stab*) examines the ability of the ruling government to stay in office and fulfilling their election manifesto. The risks are calculated based on three sub-components namely government unity, legislative strength and popular support. Socioeconomic conditions (*socio*) capture the risks of social dissatisfaction arising from socioeconomic pressures with unemployment, poverty and consumer confidence as sub-components. Internal conflict (*int_con*) assesses the risk of civil war, civil disorder and political violence that can potentially harm the governance. This also includes whether the ruling government engage in arbitrary violence against its people, armed or civil opposition to the government and on-going civil war. Corruption (*cor2*) examines corruption in the political system. Three of institutional political variables, namely, corruption (*cor* and *cor2*), the rule of law (*lao*, *rol* and rule of law, *f*) and political violence (*int_con* and *p_stab*) from the three different databases seem to overlap. Since the measurements and definitions are entirely different, this can be considered as a robustness test.

4.2 | Classification of countries according to the regime type

The main issue in the empirical construct is how to disaggregate the countries into regime types to facilitate a meaningful empirical analysis. Such aggregation is aimed to illustrate the different requirements to maintain their power in those countries, which is later translated into how the country is being managed and policies are undertaken. Under a democratic regime, we would expect the elected party(ies) to adopt policies that would benefit the majority of the citizens in the country to ensure their political survival. Leaders in democratic regimes are presumed to avoid costly short-term policies to safeguard their tenure. Cheibub et al. (2010), Steinberg and Malhotra (2014), Hadenius and Teorell (2007), Magoloni (2006), Lai and Slater (2005), Debs and Goemans (2010) generally classify the countries in their study into democracy and authoritarian regimes. Authoritarian regimes are then categorized into monarchies, military regime and civil dictatorship. Tongur et al. (2015), for example, classify democracy into a social democracy, conservative democracy and one-party democracy while autocracy is divided into dictatorship and military dictatorship. However, Collins (2006) argue that political power distribution varies amongst countries which requires a more restrictive definition. Accordingly, Malaysia is classified as a competitive authoritarian regime, while UAE is considered as a tribe-based authoritarian regime, while most of the studies consider Malaysia democratic through a functional definition. In summary, there are different arguments as to how they classify the countries into different regimes.

In this article, selected Muslim countries are classified into autocratic and democratic regimes only which is mainly dictated by the availability of data. Accordingly, a country is categorized as democratic if the *polity2* score is higher than 5 and holds regular elections. Otherwise, the countries are categorized as autocratic. This division allows us to examine the overall and specific impact on Islamic banks in both regimes. Further disaggregation of countries under autocratic and democratic regimes through the articulation of particularities leads to fewer observations, which may affect the efficiency of the estimation.

4.3 | Sample

The analysis in this article includes a sample of 16 Muslim majority countries from 2000 to 2013. The choice of countries and time range is substantially limited by the availability and the consistency data. Asa can be seen in Table A1 (*see* Appendix), a total of 138 banks were crossed examined. This sample consists of 69 conventional banks and 69 Islamic banks with 54 banks from autocratic regimes and 15 banks from democratic regimes. The sample is divided into four categories: conventional and Islamic banks, Islamic banks only, Islamic banks in the democratic regime and Islamic banks in autocratic regimes.

The sample only includes banks with 5 years or more observations to capture the impact of politics since shorter time span may not be able to capture such an institutional impact. In the sample, democratic countries include Turkey, Malaysia, Indonesia, Bangladesh and Pakistan. GCC countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates), Yemen, Egypt, Iran, Sudan and Jordan represent the autocratic regime-based countries in the sample.

4.4 | Estimation method

Our empirical model is based on Baum et al. (2010) which takes the following form:

$$\text{Loan growth}_{it} = \alpha_0 + \gamma B_{it} + \varphi E_{it} + \tau M_{it} + v_i + \varepsilon_{it}$$

where i and t denote bank and time, respectively, and γ, τ and φ are vectors of coefficients on the bank-specific factors, crisis dummies and institutional factors. v_i captures the banks fixed effects, and ε_{it} denotes the error term. The elements of B control for bank-specific factors which may affect loan growth. Total assets (*ta*) is used to control for the size of the bank and the effect of economies of scale. Deposits over total loan (*dtl*), a proxy for liquidity, is included to measure the density of financial strength that could be used to give out loans. In addition, a set of institutional data (E) are used to represent the political regime, governance and political risks. Finally, a crisis dummy (M) is introduced to capture the macroeconomic effects.

Based on initial inspection of the data, there are variations across the institutional variables within each country. Even within the autocratic and democratic regimes, the degree of autocracy and democracy varies significantly across the sample of countries, prompting the use of fixed-effect panel regression models. The autocratic regime in the sample comes in the form of autocracy, oligarchy and monarchy. Following institutional changes due to the political upheaval following Arab Spring in 2011 and the possibility that the effect will proliferate to neighbouring Arab countries, we resort to the use of fixed-effect method. Fixed-effect approach is used to control for country-specific time-invariant traits that are not accounted for by the control variables in our empirical model.

To introduce dynamism in the static model, we use lagged variables in two control variables: total asset (*ta*) and deposit over total loan (*dtl*). For robustness check, we employed GLS (generalized least squares) and GMM econometric models. GLS with AR(1) correction is employed to accommodate the effect of autocorrelation and heteroscedasticity (Phillips et al., 2013). In addition, GLS is more efficient compared to feasible GLS in small to medium size sample. However, estimation using fixed-effect approach and GLS may be biased due to the introduction of lagged dependent variables among the regressors, which may lead to reverse causality. To partly assuage this problem, we supplement the empirical results with GMM estimation (Blundell & Bond, 1998), which aims at tackling the problem of endogeneity and reverse causality. Depending on the source of endogeneity bias, the institutional and economic effects on loan growth can be either over or under-estimated. Since the number of external instruments to address all potential endogenous variables are limited, GMM relies on the lags of the regressors as instruments circumventing endogeneity and reverse causality bias.

4.5 | Preliminary statistics

Table 2 presents descriptive statistics for the primary variables, while Table A3 (*see* Appendix) provides autocorrelation results. As can be seen, none of the variables is highly correlated, which allow bundling of sub-categories variables according to political regimes, governance and political risks in regressions. The countries selected are vastly different in terms of size, political ideology, culture, and income, which may potentially lead to non-stationary heteroscedasticity. To deal with this issue, we rely on panel unit root tests proposed by Herwartz and Siedenburg (2008), t_{HS}, and Demetrescu and Hanck (2012), t_{DH}, which caters for cross-sectional dependence and non-stationary heteroscedasticity. Table A4 (*see* Appendix) presents the HS and DS test statistics, which shows that the data is stationary at level. Additionally, the usual panel unit root tests, LLC, IPS, ADF-Fisher and PP-Fisher are also applied to the variables.[3]

Unit root test results show that all variables except *demo*, *auto* and *g_stab* are stationary or *I(0)* in at least one of the tests, corroborating the use of the basic panel data models rather than the PMG-type models which deal with stationarity. However, to introduce dynamism into the equation, we introduce lagged values for the bank-specific effects. For robustness check, we employ feasible GLS and GMM.

5 | POLITICAL REGIMES, GOVERNANCE QUALITY AND POLITICAL RISK, AND LOAN PERFORMANCE OF ISLAMIC BANKS: FINDINGS

The empirical analysis and results in this section are divided into two parts. The first part reports the impact of political regime, governance and political risks on financing or loan growth. In the second part of the results, we introduce interaction variables between loan growth and all the institutional variables. These interaction variables are expected to capture the short-run impact of institutional behaviour on loan growth and their marginal effects.

TABLE 2 Descriptive statistics of main variables: Overall sample

Variable	Mean	*SD*	Min	Max
loan growth	0.0071	0.0170	−0.0815	0.1758
size	6.8820	1.1531	3.3152	8.9621
liquidity	0.4732	0.2302	0.0119	0.9903
polity2	−5.7556	3.1870	−10	3
demo	0.4075	0.9221	0	4
auto	6.1630	2.5028	0	10
pr	5.9259	0.8794	4	7
cl	6.1323	0.8079	4	7
cor	−0.3125	0.8390	−1.5066	1.7228
g_eff	−0.3309	0.7851	−1.4577	1.1379
p_stab	−0.9062	1.1502	−2.6600	1.2125
reg	−0.4154	0.9231	−1.7305	1.1161
rol	−0.3762	0.8666	−1.5984	1.0324
va	−1.2220	0.4333	−1.8568	−0.1897
ten	12.6369	7.8458	1	33
g_stab	0.7680	0.1352	0.4167	0.9583
socio	0.4574	0.2193	0.125	0.9167
cor2	0.4674	0.2757	0	1.1667
lao	0.4446	0.2830	0.1667	0.8333
dem_acc	0.5887	0.2023	0	1
int_con	0.6797	0.1515	0.0000	1

5.1 | The relationship between loan growth, political regime, governance and political risks

The econometric analyses are divided into four subsamples: overall sample which covers all banks in conventional and Islamic banking, Islamic banks only, Islamic banks in the democratic regime and Islamic banks in an autocratic regime. The result of the control variables generally conforms to the theoretical prediction. Log of total assets (*size*) and deposit as a ratio of the total loan (*liquidity*) are used to control for the size and liquidity of the banks, respectively. Size of the bank (*ta)* is positive and significant in all regressions for the overall sample, implying bigger banks are capable of offering more loans. For the sub-categories, only a few regressions have a positive and significant effect. Nevertheless, *size* is still positive for all other regressions albeit being insignificant. While results, hence, imply that higher liquidity (*liquidity*) promotes higher loan growth, liquidity is both positive and significant in overall sample but becomes insignificant in the subsamples.

The hypothesis that political institutions matter for loan growth has explicit empirical support which provides evidence for H1. *Polity2* variable is both positive and significant. Tables 3 and 4 show that political regime matters for loan growth. As the degree of democracy (*demo*) improves, loan growth is positive and significant. Similarly, as the degree of autocracy increase, loan growth is negative and significant implying lower growth rates in the autocratic regime compared to a democratic regime. This is indicated by the positive sign of *polity2* and *demo*, while *auto* is negative in Table 3. Thus, H1 is supported by some of the findings; however, when it comes to the more specific aspects of the political regime variables, the results demonstrate distinctions. As can be seen, three of the polity component variables are negative and significant. More standardized procedures for executive power transfer (*xrreg*), more competitive selection of executive (*xrcomp*) and more regulated participation (*parreg*) leads to slower loan growth. When the sample is reduced to Islamic banks, only executive power transfer (*xrreg*) and regulated participation (*parreg*) is negative and significant. Taking into account Islamic banks in democratic countries, executive transfer (*xrreg*) and selection of executive (*xrcomp*) is negative and significant. Executive constraint (*xconst*) is marginally negative and significant in democratic regime cases, which means that accountability group (for example, legislator and judiciary) has the power to limit executive (for example, president, king, cabinet) decisions. The negative relationship between *xconst* and loan growth implies that with a limited constraint on the executive, loan growth can grow more as oppose to if the accountability group overrides the executive decisions.

As for the concept variables, executive recruitment (*exrec*) is positive and significant across all samples. This suggests that more institutionalized, open and competitive mechanisms of political leader selection promote positive loan growth. The competitive selection that results in leaders that are competent and pro-business will device growth-enhancing policies, which eventually lead to more businesses. As the results evidence, executive constraint (*exconst*) is negative and significant in all samples. Results imply that less constraint on executive authority leads to higher loan growth as decisions can be implemented with minimum interference. Therefore, pro-business policies can be undertaken effectively with minimal political intervention.

The results of the extended model which uses data from an alternative source are reported in Table 4. Political rights (*pr*) and civil liberties (*cl*) are both negative and significant indicating that loan growth is positive as countries move more towards democracy. All the sub-category variables for political rights are significant. As the

TABLE 3 Impact of political regime on loan growth (Dependent variable: Loan growth)

	Overall sample (Islamic and Conventional banks)					Islamic banks				
Variables	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
size	0.5458*** (0.0944)	0.8375*** (0.0928)	0.5461*** (0.1125)	0.9078*** (0.0929)	0.7180*** (0.0976)	0.0010 (0.0009)	0.0009 (0.0009)	0.0011 (0.0009)	0.0022** (0.0010)	0.0025** (0.0010)
liquidity	0.0494** (0.0225)	0.1653*** (0.0224)	0.0267 (0.0274)	0.1785*** (0.0238)	0.5612*** (0.0519)	0.0101*** (0.0036)	0.0097*** (0.0037)	0.0107*** (0.0036)	0.0135*** (0.0040)	0.0153*** (0.0040)
c	4.6602*** (0.6257)	7.3672*** (0.6268)	3.8298*** (0.7487)	11.3982*** (1.1940)	3.3380*** (0.8975)	0.0116 (0.0085)	0.0082 (0.0082)	0.0149* (0.0088)	0.0299** (0.0137)	0.0214** (0.0097)
crisis	−3.1052*** (0.8776)		−1.1196 (1.0230)	−2.8649*** (0.8467)	−2.2039*** (0.8295)	−0.0207** (0.0104)	−0.0199* (0.0104)	−0.0206** (0.0103)	−0.0180* (0.0105)	−0.0178* (0.0106)
polity2	0.3225*** (0.0158)					0.0003* (0.0001)				
demo		0.4013*** (0.0185)		0.6248*** (0.0779)	0.3740*** (0.1410)		0.0003 (0.0003)		0.0013 (0.0020)	0.0011 (0.0013)
autoc			−0.1824*** (0.0311)					−0.0006** (0.0003)		
xrreg				−0.6242*** (0.1831)					−0.0029** (0.0013)	
xrcomp				−0.6231*** (0.2178)					0.0020 (0.0027)	
xopen				0.1663 (0.1083)					0.0005 (0.0009)	
xconst				−0.2247 (0.1643)					−0.0009 (0.0011)	
parreg				−0.6357*** (0.1553)					−0.0019* (0.0011)	
parcomp				0.1386 (0.1582)					0.0003 (0.0014)	
exrec					0.5887*** (0.0843)					0.0024*** (0.0008)
exconst					−0.6166*** (0.1741)					−0.0033*** (0.0011)
polcomp					−0.0064 (0.0630)					0.0003 (0.0004)
obs	1,012	1,012	1,012	1,012	782	612	612	612	612	590
Within R^2	0.5685	0.5837	0.4063	0.6190	0.6573	0.0328	0.0404	0.0360	0.0403	0.05000
Between R^2	0.2902	0.2674	0.2198	0.4492	0.5866	0.0306	0.0363	0.0280	0.0361	0.0384
Overall R^2	0.5113	0.4711	0.4016	0.5512	0.6119	0.0673	0.0749	0.0693	0.0752	0.0809
F-test	3.21 (0.000)	3.85 (0.000)	6.34 (0.000)	3.31 (0.000)	3.58 (0.000)	4.68 (0.000)	4.58 (0.000)	4.72 (0.000)	4.60 (0.000)	4.55 (0.000)

	Islamic banks in democratic regime		Islamic banks in autocratic regime	
Variables	**11**	**12**	**13**	**14**
size	0.0214*** (0.0067)	−0.0224*** (0.0081)	−0.0013 (0.0010)	−0.0023** (0.0010)
liquidity	0.0618*** (0.0231)	0.0760*** (0.0281)	0.0120*** (0.0039)	0.0142*** (0.0038)
c	0.3110*** (0.0846)	0.1502 (0.0907)	0.0140 (0.0120)	0.0071 (0.0113)

(Continues)

TABLE 3 (Continued)

	Islamic banks in democratic regime		Islamic banks in autocratic regime	
Variables	**11**	**12**	**13**	**14**
crisis	−0.0102 (0.0186)	−0.0006 (0.0202)	−0.0002 (0.0023)	−0.0002 (0.0022)
xrreg	−0.0593** (0.0228)		−0.0081*** (0.0031)	
xrcomp	−0.0083** (0.0042)		0.0154** (0.0062)	
xopen	−0.0137 (0.0098)		−0.0020* (0.0011)	
xconst	−0.0052* (0.0027)		−0.0001 (0.0014)	
parreg	−0.0084 (0.0063)		−0.0007 (0.0018)	
parcomp	0.0078 (0.0069)		0.0002 (0.0014)	
exrec		−0.0108** (0.0051)		0.0032** (0.0013)
exconst		−0.0153*** (0.0047)		−0.0015 (0.0012)
polcomp		0.0001 (0.0030)		0.0002 (0.0006)
obs	138	112	478	478
Within R^2	.1899	.1750	.0461	.0489
Between R^2	.4325	.2886	.7274	.3954
Overall R^2	.0850	.1112	.0586	.0707
F-test	3.66 (0.000)	3.61 (0.000)	3.40 (0.000)	3.10 (0.000)

Notes: ***, ** and * represent 1%, 5% and 1% significance level. Robust standard errors are in parentheses for the coefficients. *p*-Values are in parentheses for *F*-statistics.

results show, free election process (*a*) and political pluralism and participation (*b*) promotes positive loan growth in the overall sample. Functioning of the government, however, does not necessarily lead to higher loan growth. The sub-categories are not significant in the sub-samples except for functioning of the government in the case of Islamic banks in democratic regimes. As evidenced in the results, three civil liberties (*cl*) sub-components are significant: freedom of expression, free media (*d*), and more associational and organizational rights (*e*) promote loan growth in the overall sample. The rule of law, on the other hand, is negative and significant implying lax legal enforcement is beneficial towards loan growth. Similarly, the sub-categories are insignificant in the sub-samples.

The impact of the crisis dummy variable (crisis) is both negative and significant in the overall sample. However, when the sample is split into other sub-sample, the crisis is no longer significant but retained the negative effect in almost all regressions. One possible explanation is that Islamic banks are too small to be impacted by the crisis and the use of non-varying or fixed rate cushioned the effect of crises along with the fact that the business cycles in the sampled countries were not profoundly and adversely affected by the global financial crisis. Similar findings by Ghosh (2015) suggest that the Arab Spring did not affect loan growth nor political transition.

The results demonstrate that the election dummy variables are negative and significant in the overall sample, which implies that elections create some kind of uncertainty for bankers and potential customers, which affects loan growth. As for Islamic banks in democratic regime sub-sample, election variable is negative, but pre-election dummy variable is positive, which indicates the classic political business cycle argument where incumbent government portrays right economic conditions prior to the election through manipulating the economy. Thus,

TABLE 4 Impact of political regime on loan growth (Dependent variable: Loan growth)

	Overall sample (Islamic and Conventional banks)					Islamic banks				
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
size	0.6061*** (0.0966)	0.8359*** (0.0945)	0.7215*** (0.0930)	0.8704*** (0.0964)	0.8413*** (0.0922)	0.0012 (0.0009)	0.0002 (0.0009)	0.0009 (0.0009)	0.0007 (0.0010)	0.0008 (0.0009)
liquidity	0.1021*** (0.0231)	0.0648*** (0.0244)	0.0972*** (0.0222)	0.0777*** (0.0245)	0.1614*** (0.0224)	0.0120*** (0.0037)	0.0126*** (0.0042)	0.0110*** (0.0037)	0.0160*** (0.0042)	0.0099*** (0.0037)
c	10.4504*** (0.7122)	5.9104*** (0.5887)	11.2417*** (0.6903)	4.5240*** (0.5860)	7.7083*** (0.6286)	0.0040 (0.0083)	−0.0058 (0.0085)	0.0058 (0.0084)	0.0060 (0.0092)	0.0086 (0.0083)
crisis	−1.0759 (0.8948)		−2.2641*** (0.8632)		−3.6657*** (0.8660)	−0.0183* (0.0103)				
demo					0.4258*** (0.0195)					0.0003 (0.0003)
pol_rights	−1.2589*** (0.0677)					0.0009 (0.0007)				
elec_proc		0.5781*** (0.0634)					0.0002 (0.0006)			
pol_plu		0.3755*** (0.0653)					−0.0004 (0.0006)			
func_gov		−0.9988*** (0.1098)					0.0006 (0.0010)			
civ_liberty			−1.0861*** (0.0511)					0.0002 (0.0006)		
f_expression				0.1461** (0.0680)					−0.0007 (0.0006)	
org_rights				0.8635*** (0.0682)					0.0013** (0.0006)	
rule_law				−0.5654*** (0.0979)					−0.0005 (0.0007)	
ind_rights				0.0868 (0.0899)					−0.0003 (0.0006)	
elec					−0.9556*** (0.2645)					−0.0001 (0.0022)
b_elec					−0.4539* (0.2592)					0.0023 (0.0022)
p_elec					−0.6707** (0.2656					−0.0010 (0.0023)
obs	1,014	793	1,014	793	1,012	614	502	614	502	612
Within R^2	.5462	.6782	.5793	.6722	.5904	.0297	.0318	.0278	.0414	.0321
Between R^2	.5802	.9177	.3887	.8362	.2891	.0563	.1596	.0560	.0776	.0472
Overall R^2	.5410	.6778	.5472	.6672	.4782	.0680	.0275	.0671	.0414	.0675
F-test	3.93 (0.000)	2.28 (0.016)	3.01 (0.000)	3.46 (0.000)	3.88 (0.000)	4.51 (0.000)	3.72 (0.000)	4.49 (0.000)	3.41 (0.001)	4.51 (0.000)
	Islamic banks in democratic regime					**Islamic banks in autocratic regime**				
	11	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	
size	0.0149*** (0.0054)	0.0207 (0.0074)	0.0103** (0.0051)	0.0156** (0.0067)	0.0140** (0.0058)	0.0016* (0.0009)	0.0004 (0.0009)	0.0014 (0.0009)	0.0003 (0.0009)	
liquidity	0.0333 (0.0220)	0.0482* (0.0255)	0.0239 (0.0223)	0.0430 (0.0256)	0.0278 (0.0219)	0.0115*** (0.0035)	0.0111*** (0.0039)	0.0110*** (0.0035)	0.0149*** (0.0039)	

(Continues)

TABLE 4 (Continued)

	Islamic banks in democratic regime					Islamic banks in autocratic regime			
	11	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**
c	0.0856** (0.0419)	0.1461* (0.0852)	0.0660 (0.0417)	0.2040** (0.0955)	0.1137 (0.0499)	−0.0097 (0.0064)	−0.0017 (0.0097)	0.0106 (0.0086)	0.0067 (0.0100)
crisis	−0.0247 (0.0190)		−0.0149 (0.0169)		−0.0183 (0.0199)				
pol_rights	0.0092** (0.0042)					0.0029** (0.0012)			
elec_proc		0.0119 (0.0086)					0.0008 (0.0008)		
pol_plu		0.0004 (0.0027)					−0.0004 (0.0005)		
func_gov		−0.0081** (0.0039)					−0.0006 (0.0012)		
civ_liberty			0.0026 (0.0027)					−0.0003** (0.0001)	
f_expression				−0.0010 (0.0033)					−0.0010 (0.0006)
org_rights				0.0010 (−0.0041)					0.0008 (0.0009)
rule_law				0.0011 (0.0041)					−0.0004 (0.0007)
ind_rights				−0.0069 (0.0052)					−0.0002 (0.0006)
elec					−0.0152** (0.0075)				
b_elec					0.0222*** (0.0079)				
p_elec					0.0020 (0.0074)				
obs	131	110	131	110	131	472	381	471	381
Within R^2	.0856	.1058	.0548	.1017	.1299	.0364	.0414	.0341	.0552
Between R^2	.0478	.1831	.0176	.1968	.0143	.9009	.5853	.0793	.1616
Overall R^2	.0274	.1076	.0329	.1090	.0801	.0435	.0213	.0268	.0427
F-test	6.65 (0.000)	1.23 (0.291)	3.24 (0.000)	1.10 (0.3738)	3.2 (0.001)	3.89 (0.000)	4.12 (0.000)	4.06 (0.000)	3.72 (0.000)

Note: ***, ** and * represent 1%, 5% and 1% significance level. Robust standard errors are in parentheses for the coefficients. *p*-Values are in parentheses for *F*-statistics.

depending on period, H2 is supported, as pre-election dummy variable results in the expansion of loan in Islamic banks, but overall election variable has negative impact. This refers to mixed result for the H2.

As the results reported in Table 5, all indicators of governance are significant in the overall sample providing variable based support for H3, as in certain institutional and governance variables there is a positive impact; however, negative impact is produced in the case of other governance variables. As can be seen in the results, government effectiveness (*g_eff*), political stability (*p_stab*), regulatory quality (*reg*) and voice and accountability (*va*) have positive impact on loan growth whilst control of corruption (*cor*), the rule of law (*rol*) and tenure (*ten*) have negative impact on loan growth. Corruption (*cor*) has negative impact in democratic regime but positively affect loan growth in an autocratic regime. In democratic regimes where the market is almost fully functioning, corruption disrupts its efficiency while in an autocratic regime where the market is not efficient;

TABLE 5 Impact of governance on loan growth (Dependent variable: Loan growth)

	Governance			
	Overall	**Islamic**	**Democratic**	**Autocratic**
	1	**2**	**3**	**4**
size	0.9386*** (0.0856)	0.0014 (0.0011)	0.0317*** (0.0091)	0.0012 (0.0011)
liquidity	0.0811*** (0.0206)	0.0139*** (0.0043)	0.0490* (0.0257)	0.0133*** (0.0041)
c	10.6029*** (0.7454)	0.0431 (0.0161)	0.2649*** (0.0882)	0.0018 (0.0100)
crisis	−1.1842 (1.0055)	−0.0831*** (0.0265)		
cor	−2.2403*** (0.3077)	−0.0025** (0.0012)	−0.0123** (0.0062)	0.0099* (0.0051)
g_eff	1.2281*** (0.3226)	0.0113*** (0.0039)	0.0041 (0.0250)	0.0093* (0.0054)
p_stab	0.6255*** (0.2003)	−0.0051* (0.0027)	0.0066 (0.0170)	−0.0031 (0.0037)
reg	1.8476*** (0.3434)	−0.0029** (0.0012)	−0.0134** (0.0065)	−0.0072** (0.0034)
rol	−4.3364*** (0.4554)	−0.0033** (0.0014)	−0.0096* (0.0056)	0.0021 (0.0055)
va	2.7031*** (0.1778)	−0.0039* (0.0039)	−0.0494** (0.0238)	−0.0203*** (0.0058)
ten	−0.0417*** (0.0101)	−0.0001 (0.0013)	−0.0003 (0.0010)	−0.0003** (0.0001)
obs	912	523	116	351
Within R^2	.6959	.0740	.1650	.921
Between R^2	.6616	.0583	.2072	.5576
Overall R^2	.6799	.0622	.0383	.0596
F-test	3.01 (0.001)	5.48 (0.000)	3.62 (0.001)	3.17 (0.001)

Note: ***, ** and * represent 1%, 5% and 1% significance level. Robust standard errors are in parentheses for the coefficients. *p*-Values are in parentheses for *F*-statistics.

corruption expedites loan processes which leads to faster approval and money being channelled into businesses. As can be seen, government effectiveness (*g_eff*) is the only significant in all Islamic banks and Islamic banks in autocratic regimes sub-sample. Regulatory quality (*reg*) is positive in the overall sample but negative in all other sub-samples. One possible explanation is that the regulatory quality for Islamic banks is still underdeveloped and that the existing regulatory quality is not in favour of Islamic banks which undermines loan growth in Islamic banks. The rule of law (*rol*) is negative and significant in all samples except for the Islamic banks in autocratic regimes sub-sample. These results are consistent with earlier findings using Freedom House data. Furthermore, voice and accountability (*va*) variable is positive in the overall sample but negative in all sub-samples. This indicates that freedom of expression, free media and freedom of association may undermine Islamic banking especially with negative stigma attached to Islam and Muslims.

Muslim customers may opt for a loan in conventional banks with lower interest rates *vis-a-vis* loans from Islamic banks with a higher rate of return or bank charges. They can be divided into two distinct categories. The first category is the ones who patronize Islamic banking as a tool for *Shari'ah* compliant transactions and other businesses as part of their worship to God. Therefore, regardless of the media portrays, they will stick to Islamic banking during good and adverse circumstances. The second category consists of Muslims but those who do not practice Islam as a way of life, who is the opportunist

who would take advantage of the best available rate regardless of whether the transaction is permissible or otherwise. Finally, longer tenure (*ten*) is found to be harmful to loan growth. This indicates lack of innovative policies to capture the dynamic international and domestic markets, since the incumbent government may choose to remain faithful to old policies.

The results in Table 6 shows that four political risk variables significantly affect loan growth, which provides partial support for H4, as in the case of some political variables negative impact is located. As the results depicts, democratic accountability (*dem_acc*) and law and order (*lao*) has positive effect on loan growth, while government stability (*g_stab*) and internal conflict (*int_con*) negatively affect loan growth for the overall sample. However, results for the sub-samples are mixed. Law and order (*lao*) is negative and significant in all subsamples reflecting either crime rate or lack of impartiality in the judiciary system affecting loan growth. In the case of a democratic regime, the absence of violence and other political disorder, coupled with low socioeconomic pressures supports the growth of loan. As for autocratic regimes, higher corruption, lack of impartiality in the judiciary system and high crime rate seem to suppress loan growth.

5.2 | Robustness check

We run the overall sample and Islamic banks sample using GLS and GMM for robustness check. In the case of feasible GLS, we report the estimation allowing the presence of heteroscedasticity and AR(1) correction for autocorrelation. For GMM, the instruments are limited to a maximum of two-lags to avoid the problem of 'too many instruments' (Roodman, 2009). In the case of Islamic banks in democratic and autocratic countries, GMM is inefficient since the number of observations is inadequate.

As the results in Table 7 displays, generally, results are reasonably consistent with the previous section regarding significance and signs. Bank-specific factors are consistently positive albeit being insignificant in a few regressions. For the institutional variables, *polity2* is both negative and significant with the disaggregated effect of being in a democratic regime (*demo*) is positive and significant and negative for the autocratic regime (*auto*). More specific disaggregation of institutions, however, are not significant.

The alternative variables to capture political regime which focuses on political rights and civil liberties are both negative and significant which again indicate the lack of these two criteria in our sample. Results in Table 8 are partly contributed by the larger sample of banks from autocratic countries, which depicts that political rights as captured by the electoral process, political pluralism and functionality of the government are all significant. It should be noted that the functionality of the government is negative and the other two criteria are positive. On a similar note, the sub-variables for civil liberty are significant with freedom of expression, organizational rights and individual rights positively affecting loan growth. Having the rule of law significant and negative implies that more efforts to be expedited for law enforcement in the majority of the sampled countries. The results are consistent with the findings in the previous section for the overall sample. However, when the sample is restricted to Islamic banks only, all institutional variables except freedom of expression are no longer significant.

Lastly, Table 9 presents the results for the impact of governance and political risks on loan growth. The significance and signs of the coefficients mirror the results from the previous section. In summary, the results are fairly robust in terms of significance and sign in the majority of the regression.

5.3 | The marginal impact of political regime, governance and political risks on loan growth

The results in Section 5.1 illustrate the direct impact of political variables on loan growth. In this section, we estimate interaction terms to locate the effect of loan growth change when the political variables change. In other words, the marginal effect is approximated to examine how much loan growth is expected to increase or decrease given changes in the political variables. It should be noted that no conditional or multiplicative interactions are involved, which rules out the problems of omitted terms, as it makes interpretations of marginal effects invalid and the need for interpretations in terms of odd ratios, incidence ratios or hazard ratios.

Table 10 reports the summarized estimation results of the interaction variables testing for the short run and marginal impact of political variables on loan growth for the overall sample, Islamic banks only, Islamic banks in the democratic regime and Islamic banks in autocratic regimes. All regressions use the same set of control variables as presented in Table A2 (*see* Appendix). The overall results suggest that political stability plays a vital role towards loan growth. Pre-election year dummy variable has a significant impact on loan growth suggesting an opportunistic behaviour of the ruling government toward elections in the following year. This reflects signs of economic manipulation a year before elections under the

TABLE 6 Impact of political risk on loan growth (Dependent variable: Loan growth)

Political risks				
	Overall	**Islamic**	**Democratic**	**Autocratic**
	5	**6**	**7**	**8**
size	0.7291***	0.0021**	0.0243***	0.0011
	(0.1054)	(0.0010)	(0.0077)	(0.0008)
liquidity	0.0449*	0.0127***	0.0312	0.0111***
	(0.0247)	(0.0038)	(0.0230)	(0.0035)
c	12.4441***	1.0343**	0.2484**	0.0053
	(1.2219)	(0.0138)	(0.0948)	(0.0074)
crisis	−2.0809**	−0.0181*	−0.0104	
	(0.9825)	(0.0107)	(0.0208)	
g_stab	−7.6887***	−0.0086	−0.0008	−0.0042
	(0.8841)	(0.0074)	(0.0272)	(0.0109)
socio	−1.4471	0.0028	0.0468**	0.0106*
	(0.9257)	(0.0079)	(0.0229)	(0.0055)
cor2	−1.2734*	0.0036	0.0126	−0.0097**
	(0.6614)	(0.0050)	(0.0141)	(0.0045)
lao	2.5273***	−0.0117***	−0.0397*	−0.0095**
	(0.7865)	(0.0039)	(0.0231)	(0.0040)
dem_acc	3.7970***	−0.0077*	0.0071	−0.0067
	(0.5869)	(0.0045)	(0.0296)	(0.0074)
int_con	−4.4506***	−0.0039	0.0687**	0.0025
	(1.2792)	(0.0121)	(0.0295)	(0.0132)
obs	981	605	136	409
Within R^2	.5149	.0485	.1185	.0407
Between R^2	.5028	.0325	.2854	.4729
Overall R^2	.5108	.0824	.0231	.0545
F-test	3.32	4.55	3.39	3.56
	(0.000)	(0.000)	(0.000)	(0.000)

Note: ***, ** and * represent 1%, 5% and 1% significance level. Robust standard errors are in parentheses for the coefficients. *p*-Values are in parentheses for F-statistics.

democratic regime to increase popularity, as in the case of Alesina (1988). Based on Nordhaus' (1975) political business cycle model, the opportunistic incumbent government implements an expansionary monetary policy to temporarily expand economic activities, which is conducted by increasing bank loans to government, businesses and individuals leading to intensification of loan disbursement or 'easy' loans leading to higher loan growth. In the overall sample, all the election, pre-election and post-election dummy variables are significant implying displacement effect. While the results relating to pre-election year indicate growth in loans due to government's manipulation of the economy or artificially boosting the economy, government, businesses and the general public may become accustomed to such 'easy' loans and the trend may continue even after the elections. We argue that the Peacock-Wiseman (1961; *see* also, Henrekson, 1990) hypothesis of displacement effect of tax-government expenditure nexus may apply in our context of loan growth pre- and post-election periods in the sense that pre-election loan growth replaces the natural trend by taking the pace of loan growth to a higher level.

The evidence presented on political risks is rather clear; as the results suggest lower political risks promote loan growth. The loan growth-government stability interaction suggests government unity, legislative strength and popular support smooths government's ability to fulfil their declared manifestoes and policies. Stability also means the incumbent government has the ability to win the election to stay in the office after elections, which enables them to carry out any long-term policies. The

TABLE 7 Impact of political regime on loan growth (Overall sample: Conventional and Islamic banks, Dependent variable: Loan growth)

Overall sample (Islamic and Conventional banks)										
	1		**2**		**3**		**4**		**5**	
Regression	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**
size	0.7215***	0.6523***	0.8373***	0.6525***	0.8542***	0.6764***	0.9022***	0.7598***	0.7185***	0.7251***
	(0.2658)	(0.2407)	(0.3271)	(0.2315)	(0.2839)	(0.2254)	(0.3246)	(0.2354)	(0.2699)	(0.1987)
liquidity	0.1107***	0.1003**	0.1651***	0.1005***	0.1361***	0.1102***	0.1655***	0.1565***	0.1956***	0.1675**
	(0.0356)	(0.0431)	(0.0224)	(0.0412)	(0.0456)	(0.0374)	(0.0573)	(0.0587)	(0.0736))	(0.0684)
constant	2.7420**	3.7532**	2.3672***	3.6544**	2.5983***	3.9456**	3.1006***	3.7954**	3.2119***	2.7590**
	(1.2352)	(1.5320)	(0.6268)	(1.5164)	(0.8960)	(1.5422)	(0.8449)	(1.5479)	(0.9991)	(1.0820)
crisis	−1.2854***	−1.1255**	−1.2123***	−1.1226**	−1.3009**	−1.2039**	−1.5310**	−1.8512**	−1.6544**	−2.3225**
	(0.4709)	(0.4831)	(0.3898)	(0.4769)	(0.5310)	(0.4910)	(0.5912)	(0.7090)	(0.6747)	(0.9633)
polity2	−3.0025***	−3.5219***								
	(0.8831)	(0.9655)								
demo			0.4215***	0.3954***			0.5528***	0.4527***	0.5003**	0.4125**
			(0.01500)	(0.1373)			(0.1707)	(0.1286)	(0.2050)	(0.1755)
autoc					−0.2293***	−0.2543***				
					(0.0715)	(0.0792)				
xrreg							−0.6053***	−0.5428**		
							(0.1615)	(0.2162)		
xrcomp							−0.0101	−0.0052		
							(0.0237)	(0.2004)		
xopen							0.0127	0.0053		
							(0.1090)	(0.0112)		
xconst							−0.2192	−0.2009		
							(0.1768)	(0.1925)		
parreg							−0.1985	−0.2500		
							(0.1811)	(0.3215)		
parcomp							0.0365	0.0032		
							(0.1251)	(0.0134)		
exrec									0.0062	0.0425
									(0.0751)	(0.0815)
exconst									−0.0325	−0.0521
									(0.0639)	(0.0625)
polcomp									−0.0013	−0.0015
									(0.0542)	(0.0632)
Observation	1,026	296	1,026	296	1,026	286	1,026	262	796	222
Wald Chi^2 Stat	0.00		0.00		0.00		0.00		0.00	
Hansen J-test		0.596		0.599		0.574		0.523		0.498
Islamic banks										
	6		**7**		**8**		**9**		**10**	
Regression	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**
size	0.0054**	0.0096**	0.0068**	0.0105**	0.0235**	0.0266**	0.0119**	0.0291**	0.0155**	0.0253**
	(0.0022)	(0.0038)	(0.0030)	(0.0042)	(0.0093)	(0.0105)	(0.0047)	(0.0114)	(0.0061)	(0.0099)
liquidity	0.0209**	0.0532**	0.0309**	0.0352**	0.0323**	0.0453**	0.0543**	0.0498**	0.0568**	0.0512**
	(0.0083)	(0.0220)	(0.0132)	(0.0150)	(0.0124)	(0.0195)	(0.0213)	(0.0207)	(0.0232)	(0.0219)
constant	0.01056	0.1024	0.0254	0.1024	0.1324	0.2015	0.1566	0.0758	0.1059	0.1504

TABLE 7 (Continued)

Islamic banks										
	6		7		8		9		10	
Regression	GLS	GMM	GLS	GMM	GLS	GMM	GLS	GMM	GLS	GMM
	(0.0210)	(0.2543)	(0.0953)	(0.2353)	(0.3215)	(0.2354)	(0.2017)	(0.0973)	(0.2015)	(0.0932)
crisis	−0.0325** (0.0133)	−0.0452** (0.0193)	−0.0542** (0.0208)	−0.0053 (0.0102)	−0.0219** (0.0099)	−0.0095 (0.0106)	−0.0498** (0.0214)	−0.0056 (0.0152)	−0.0512** (0.0202)	−0.0048 (0.0132)
polity2	0.0124** (0.0049)	0.0254** (0.0100)								
demo			0.0023 (0.0035)	0.0036 (0.0105)			0.0012 (0.0026)	0.0014 (0.0152)	0.0017 (0.0155)	0.0015
autoc					−0.0035** (0.0016)	−0.0051** (0.0021)				
xrreg							−0.0032** (0.0014)	−0.0006 (0.0052)	−0.0033** (0.0014)	−0.0001 (0.0051
xrcomp							0.0011 (0.0045)	0.0033 (0.0102)		
xopen							0.0004 (0.0012)	0.0002 (0.0036)		
xconst							−0.0008 (0.0013)	−0.0011 (0.0016)	−0.0022 (0.0031)	−0.0012 (0.0017)
parreg							−0.0010 (0.0027)	−0.0012 (0.0056)	−0.0019 (0.0018)	−0.0015 (0.0053)
parcomp							0.0002 (0.0032)	0.0003 (0.0045)	0.0003 (0.0035)	0.0004 (0.0041)
exrec										
exconst										
polcomp										
Observation	626	178	626	178	626	178	626	95	604	107
Wald Chi^2 Stat	0.00		0.00		0.00		0.00		0.00	
Hansen J-test		0.311		0.313		0.313		0.122		0.129

Note: Standard errors are in parentheses. *** and ** denote statistical significance at 1% and 5%. The H_0 for Chi-squared test is that all the coefficients except the constant are jointly equal to zero. The Hansen J-test of over identifying restrictions test the H_0 that the instruments are valid.

interaction of socioeconomic variable and loan growth indicates lower unemployment, higher consumer confidence and lower poverty reduces risks of socioeconomic pressure and consequently promotes growth. The absence of internal conflict in the form of civil war, civil disorder or any kind of political violence promotes political stability which provides a favourable environment for banking related activities. Democratic accountability reflects lower risks for democratic countries and higher risks for autocratic countries. In this case, democratic accountability evaluates the responsiveness of the government towards public demand especially financially, as loans are essential for business expansion and individuals wanting to comfort in life (such as personal loans, car loans, housing loans). The ability of the government reacting to this requirement signals government responsiveness through public to the public.

6 | CONCLUSION

This article explored the role of political regime and institutions, governance and political risks on Islamic banking growth, proxied by loan growth across both conventional and Islamic banks in Muslim dominated countries. Our earlier hypothesis is that there exists a

TABLE 8 Impact of political regime on loan growth (Overall sample: Conventional and Islamic banks, Dependent variable: Loan growth)

Overall sample (Islamic and Conventional banks)										
	1		**2**		**3**		**4**		**5**	
Regression	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**
size	0.5473*** (0.1511)	0.6734** (0.2682)	0.5116*** (0.1717)	0.6642*** (0.2363)	0.7901*** (0.2431)	0.6879** (0.2635)	0.6799*** (0.2346)	0.5491** (0.2236)	0.5872*** (0.2099)	0.6176** (0.2506)
liquidity	0.3594*** (0.1012))	0.4561** (0.1801)	0.3870*** (0.1423)	0.3866*** (0.1243)	0.4532*** (0.1564)	0.4099*** (0.1497)	0.3225*** (0.9988)	0.4132*** (0.1488)	0.2861*** (0.0869)	0.4328*** (0.1219)
constant	7.3471*** (2.7415)	6.0932*** (2.1418)	5.4416*** (1.8895)	5.2768*** (1.4823)	7.3287*** (1.6247)	6.1975*** (1.6851)	4.7511*** (1.5844)	5.7429*** (1.6315)	5.7683*** (1.9234)	4.8761*** (1.4976)
crisis	−1.2017 (1.1536)	−1.1322 (1.5473)	−1.0562 (1.1254)	−1.3252 (1.4278)	−1.5471 (1.3211)	0.9976 (1.3767)	−1.0017 (1.4132)	−0.9961 (1.3872)	−0.9329 (0.8763)	−1.0245 (1.3481)
demo									0.5497*** (0.1712)	0.6753** (0.2773)
pol_rights	−1.4875*** (0.5109)	1.6785*** (0.5396)								
elec_proc			0.6859*** (0.2136)	0.7756** (0.3301)						
pol_plu			0.4686*** (0.1505)	0.4975*** (0.1360)						
func_gov			−0.5891*** (0.1971)	−0.5900** (0.2331)						
civ_liberty					−2.1197*** (0.8106)	−1.9789*** (0.5416)				
f_expression							0.1132** (0.0479)	0.2675** (0.1049)		
org_rights							0.7654*** (0.2460)	0.6423** (0.2513)		
rule_law							−0.4532*** (0.1626)	−0.0287 (0.3861)		
ind_rights							0.0098 (0.0108)	0.0079 (0.0207)		
elec									−1.2527*** (0.4142)	−1.0894** (0.4256)
b_elec									−0.0564 (0.2119)	0.0087 (0.1776)
p_elec									−0.0869 (0.1865)	0.0782 (0.1968)
Observation	1,028	297	807	182	1,028	297	807	147	1,026	274
Wald Chi^2 Stat	0.00		0.00	0.	0.00		0.00		0.00	
Hansen J-test		0.545		0.336		0.549		0.226		0.478
Islamic banks										
	6		**7**		**8**		**9**		**10**	
Regression	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**	**GLS**	**GMM**
size	0.0054 (0.0049)	0.0064 (0.0079)	0.0003 (0.0008)	0.0001 (0.0057)	0.0008 (0.0010)	0.0003 (0.0065)	0.0003 (0.0009)	0.0001 (0.0055)	0.0007 (0.0009)	0.0001 (0.0054)
liquidity	0.0322**	0.0448**	0.0115**	0.0341**	0.0113**	0.0421**	0.0125**	0.0132**	0.0133**	0.0114**

TABLE 8 (Continued)

Islamic banks										
	6		7		8		9		10	
Regression	GLS	GMM	GLS	GMM	GLS	GMM	GLS	GMM	GLS	GMM
	(0.0137)	(0.0183)	(0.0046)	(0.0145)	(0.0049)	(0.0166)	(0.0053)	(0.0052)	(0.0051)	(0.0045)
constant	0.0075 (0.0087)	0.0074 (0.0073)	−0.0053 (0.0059)	−0.0021 (0.0071)	0.0065 (0.0077)	0.0076 (0.0077)	0.0054 (0.0083)	0.0032 (0.0073)	0.0057 (0.0085)	0.0031 (0.0071)
crisis	−0.0197 (0.0201)	−0.0055 (0.0197)	−0.0101 (0.0213)	−0.0098 (0.0187)	−0.0077 (0.0211)	−0.0088 (0.0176)	−0.0065 (0.0227)	−0.0015 (0.0154)	−0.0100 (0.0097)	−0.0087 (0.0097)
demo									0.0005 (0.0006)	0.0003 (0.0011)
pol_rights	0.0013 (0.0053)	0.0009 (0.0043)								
elec_proc			0.0005 (0.0007)	0.0010 (0.0013)						
pol_plu			−0.0003 (0.0005)	−0.0004 (0.0007)						
func_gov			0.0007 (0.0011)	0.0011 (0.0087)						
civ_liberty					0.0007 (0.0011)	0.0003 (0.0045)				
f_expression							−0.0003 (0.0006)	−0.0001 (0.0011)		
org_rights							0.0142** (0.0056)	0.0098** (0.0040)		
rule_law							−0.0004 (0.0007)	−0.0002 (0.0010)		
ind_rights							−0.0002 (0.0005)	−0.0002 (0.0013)		
elec									−0.0001 (0.0023)	−0.0002 (0.0035)
b_elec									0.0027 (0.0033)	0.0033 (0.0101)
p_elec									−0.0011 (0.0035)	0.0005 (0.0056)
Observation	628	176	516	102	628	176	516	94	626	115
Wald Chi^2 Stat	0.00		0.00		0.00		0.00		0.00	
Hansen J-test		0.316		0.287		0.325		0.137		0.299

Note: Standard errors are in parentheses. *** and ** denote statistical significance at 1% and 5%. The H_0 for Chi-squared test is that all the coefficients except the constant are jointly equal to zero. The Hansen J-test of overidentifying restrictions test the H_0 that the instruments are valid.

relationship between loan growth and political institutions where good institutions promote the development of Islamic banking in terms of higher loan growth.

Results suggest that loan growth is higher in democratic regimes as compared to autocratic regimes, although more than two-thirds of the total assets in Islamic banking are within the autocratic regime-based countries mainly in the GCC region. The opportunistic political business cycle is evident in our results for democratic countries where the current ruling government artificially boost the economy to secure votes in the next elections. Interestingly, the effect of corruption differs in democratic and autocratic regime; as corruption in democratic countries negatively affect loan growth, but the effect is positive in autocratic countries implying different regime framework leading to different response and

TABLE 9 Impact of governance and political risks on loan growth (Dependent variable: Loan growth)

Governance					Political risks				
	Overall		Islamic			Overall		Islamic	
	1		2			1		2	
Regression	GLS	GMM	GLS	GMM		GLS	GMM	GLS	GMM
size	1.2451*** (0.4717)	1.0243** (0.5122)	0.0073*** (0.0025)	0.0083*** (0.0029)	Total assets	0.9544*** (0.3563)	1.0135*** (0.3099)	0.0045** (0.0022)	0.0032** (0.0015)
liquidity	0.0981** (0.0491)	0.0764 (0.0066)	−0.0014 (0.0010)	−0.0011 (0.0247)	Total loans	0.1103*** (0.0418)	0.1008*** (0.0351)	0.0221*** (0.0076)	0.0256** (0.0117)
constant	9.4211*** (3.5686)	7.9851 (3.002)	0.0544 (0.0535)	0.0643 (0.0585)	Constant	9.4358** (4.6945)	11.5421** (5.2342)	2.6341** (1.1306)	2.8250** (1.2177)
crisis	−1.3854 (1.0211)	−0.9453 (1.0052)	−0.0082 (0.0073)	−0.0069 (0.0071)	crisis	−2.3564** (1.1221)	−2.1056** (0.9031)	−0.0200** (0.0091)	−0.0191 (0.0245)
corruption	−1.2454*** (0.4681)	−0.9785 (1.1022)	−0.0049*** (0.0011)	−0.0032 (0.0029)	g_stab	−8.1569*** (3.0890)	−8.8871** (4.361)	−0.0089 (0.0078)	−0.0095 (0.0101)
g_eff	1.0125*** (0.3642)	1.3264 (1.1255)	0.0253*** (0.0047)	0.0925 (0.1005)	socio	−1.2532 (0.9965)	−1.0953 (0.9556)	0.0051 (0.0043)	0.0045(0.0039)
p_stab	0.0258 (0.2559)	0.7581 (0.6953)	−0.0072 (0.0064)	0.0043 (0.0050)	corruption2	−1.3149** (0.5717)	−1.3849** (0.5412)	0.0062 (0.0053)	0.0051 (0.0060)
reg	2.8546*** (0.9581)	2.3157** (1.1579)	−0.0058** (0.0013)	−0.0032 (0.0107)	lao	1.9987*** (0.6663)	2.0053** (0.9511)	−0.0287*** (0.0103)	−0.0252** (0.0120)
rol	−5.3654*** (1.7885)	−3.1151 (2.5975)	−0.0065*** (0.0012)	−0.0054 (0.0105)	dem_acc	3.9921*** (1.1406)	4.2695*** (1.6112)	−0.0080 (0.0065)	−0.0075 (0.0070)
va	2.9577 (1.6573)	2.3541 (1.8542)	−0.0077 (0.0059)	0.0063 (0.0114)	int_con	−3.8125*** (1.1914)	−3.2654*** (1.0035)	−0.0036 (0.0123)	−0.0025 (0.0101)
ten	−0.0113 (0.1652)	0.0344 (0.1568)	−0.0001 (0.0011)	−0.0001 (0.0045)					
Observation	922	256	535	140		973	276	599	166
Wald Chi^2 Stat	0.00		0.00			0.00		0.00	
Hansen J-test		0.345		0.202			0.415		0.211

Note: Standard errors are in parentheses. *** and ** denote statistical significance at 1% and 5%. The H_0 for Chi-squared test is that all the coefficients except the constant are jointly equal to zero. The Hansen J-test of over identifying restrictions test the H_0 that the instruments are valid.

outcomes, as such a relation in autocratic regimes might be the result of patronage or clientelism based political economy. In addition, the case of countries under autocracy, corruption speed up business processes by removing bureaucratic impediments and speeding up the processes. Results also suggest that certain political-institutional framework is designed for conventional banks, therefore, may not necessarily fit into the Islamic banking requirements. The findings also suggest that different regimes are affected by different forms of political risks *vis-à-vis* loan growth. The results show that effective socioeconomic conditions and low internal conflict provide a favourable environment for loan growth in democratic countries, while in autocratic regimes, higher corruption and lax enforcement of law amount lower loan growth.

The results cannot, however, be generalized for overall Islamic banking due to several possible caveats. First, anecdotal evidence suggests that the degree and type of democracy and autocracy vary across the sampled countries: Turkey, Bangladesh and Pakistan is a parliamentary representative democratic republic, Malaysia is a federal representative democratic constitutional monarchy and Indonesia is a presidential representative democratic republic. Saudi Arabia, Qatar and Oman reign under an absolute monarchy, while Bahrain, Kuwait, Jordan and to some extent, the UAE is under constitutional monarchy system. Yemen, Egypt, Iran and Sudan practice presidential democracy, but the actual practices are akin to those in authoritarian regime type. To alleviate this problem, we categorized the countries not according to the *de*

TABLE 10 Summary of interaction variables (loan growth × political variables; Dependent variable: Loan growth)

	Overall sample	Islamic banks	Democratic regime	Autocratic regime
Political regime				
polity2	0.1303*** (0.0027)	−0.0529*** (0.0064)		
auto				0.1432*** (0.0034)
demo			0.2408*** (0.0048)	
elec	0.7765*** (0.1335)	0.5898*** (01558)	−0.1307 (0.5009)	
b_elec	0.8230*** (0.1108)	0.9232*** (0.0429)	0.9652*** (0.0211)	
p_elec	0.9628*** (0.0351)	0.6150*** (0.1397)	0.2149 (0.7450)	
pr	0.2399***(0.0012)	0.1780*** (0.0017)		0.1617*** (0.0011)
cl	0.2589*** (0.0027)	0.1765*** (0.0019)		0.1602*** (0.0012)
Governance				
cor	−0.8444*** (0.0237)	−0.2987*** (0.0521)	1.9587*** (0.1959)	−0.4942*** (0.0426)
g_eff	−0.7980*** (0.0637)	0.2193*** (0.0397)	0.7501*** (0.0228)	−0.5372*** (0.0488)
p_stab	−0.4655*** (0.0092)	−0.3903*** (0.0282)	0.4208** (0.1752)	−0.4338*** (0.0212)
reg	−0.7811*** (0.0614)	−0.0960** (0.0441)	1.6198*** (0.0732)	−0.4113*** (0.0371)
rol	−0.9791*** (0.0284)	−0.1279*** (0.0467)	1.5311*** (0.0917)	−0.4285*** (0.0399)
va	−1.2149*** (0.0294)	−0.8101*** (0.0187)	−1.8511*** (0.0339)	−0.7136*** (0.0123)
ten	0.0481** (0.0032)	0.0678*** (0.0019)	0.1914** (0.0047)	0.0592** (0.0015)
Political risks				
g_stab	1.4193*** (0.0049)	1.2965*** (0.0089)	1.2331*** (0.0089)	1.2975*** (0.0121)
socio	2.3964*** (0.0469)	1.4258*** (0.0274)	1.2081*** (0.0161)	1.7309*** (0.0019)
int_con	1.8681*** (0.0181)	1.2779*** (0.0110)	1.1518*** (0.0105)	1.3811*** (0.0149)
cor2	2.3391*** (0.0273)	1.2222*** (0.0275)	1.0587*** (0.0129)	1.5998*** (0.0498)
dem_acc	1.4565*** (0.0073)	1.4161*** (0.0185)	1.3378*** (0.0080)	1.4813*** (0.0283)
lao	2.0542*** (0.0231)	1.6814*** (0.0441)	2.8899*** (0.0600)	1.5034*** (0.0072)

Note: Full results are available upon request. ***and ** represent 1% and 5% significance level.

jure classification but based on the de facto definition. Countries with a score of more than five from the Polity IV database are classified as democratic while countries with scores of less than five are classified as autocratic. The cut-off score is based on Eichler (2014). Second, the composition of the loan, for example, loan or financing based on *qardhassan*, *murabahah*, *mudharabah*, *musharakah*, *salam* or *istisna*[4] may also differ amongst the Islamic banks. Such differences are due to differences in *Shari'ah* interpretation. In addition, the definition of the loan may differ from one country to another. Third, given the different nature of conventional and Islamic banks, loans may not be entirely comparable across bank types even within the same country. Karim (2011) discusses the varying accounting practices across countries with Islamic banking suggesting that certain balance sheet and income statement items may not be entirely comparable across bank types even within the same country. We have endeavoured to circumvent this problem by relying on and standardizing data extraction from the same source as much as possible, for example, Bloomberg and IRTI.

An important policy implication is that the development of Islamic banking is determined very much by the political will of the ruling government or the rulers. Regardless of being democratic or autocratic, Islamic banking flourishes by given political support of the authorities which expedite decision making, creating specific sets of laws and regulation for Islamic banking, research and development in Islamic banking, Islamic banking friendly policies and regulations as well as capital for Islamic banking; all of which are lifeline for the survival of Islamic banking. Islamic banks still have to develop in term of competitiveness, maturity, sophistication, management, a technological adaptation which may explain the reason for the differences in behaviour towards political variables as identified by this study.

Islamic banking alongside with conventional banking has subsequently embraced technologies, products, marketing strategies, policies, regulations; and these seem to have converged over time. Hence, this infers that political regime is not only a determinant of Islamic banking progress, preferably, the political commitment of the ruling government is vital to set forth a stable and robust Islamic banking standing. As long as the ruling government or authority is willing to embrace financial-friendly policy framework, Islamic banking will be able to flourish anywhere implying the essential nature of the political process as an essential determinant. This is visible in the everyday practice of Islamic finance, as the Malaysian government's proactive nature in developing industry has resulted in Islamic banks and financial institutions capturing about 25% of the total financial system in the country. Similarly, the UK governments in general and the Labour governments in the first decade of the new century in particular facilitated the development of Islamic finance in the UK with the objective of making London an important Islamic finance hub, while the lack of political will in Turkey until 2013, despite the Islamic roots of AKP government, had not provided the necessary impetus for the development of Islamic finance and its financial architecture in Turkey, as Turkey has only recently become committed to developing its Islamic finance industry by generating a new model of Islamic banking industry development. Indonesia's sluggish development of Islamic finance industry can be explained in a similar vein; as until the regime change in the 1990s, the opportunity space for Islamic financial expansion was not available; and therefore, they opted for a civil society based institutional development. However, with the democratization of the country, the expansion of Islamic banking and finance and the necessary regulative architecture has gained new momentum. As these examples indicate, political environment plays an essential role in the diffusion, development and operation of Islamic finance.

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ENDNOTES

[1] While the right terminology should be 'financing' for Islamic banks due to the intended meaning suggested by the value system of Islamic moral economy, in order to ensure consistency with the existing literature as well as making a coherent comparison with conventional banks, 'loans' is used as a term for Islamic banks in this article.

[2] *Murabahah*: Sale with mark-up; *Tawarruq*: Short-term financing based on buying commodity through deferred payment and immediate sale to a third party on the spot (for further details see: Ayub, 2007; Asutay, 2015).

[3] Results are not reported to conserve space but available upon request.

[4] *Murabahah*: Sale with mark-up; *Mudarabah*: Profit sharing; *Qardhassan*: Benevolent loan; *Musharakah*: Partnership; *Salam*: Payment for deferred delivery of goods; *Istisna'*: Payment made in stages according to work progress; *Tawarruq*: Short-term financing based on commodity buy and immediate sale; *Sukuk*: Islamic bonds (for further details see: Ayub, 2007, Asutay, 2015).

DATA AVAILABILITY STATEMENT

The data that support the findings of this study are available from the corresponding author upon reasonable request.

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APPENDIX

TABLE A1 Samples banks

Country	Islamic banks	Conventional banks
Bahrain	Venture Capital Bank	Gulf International Bank
	Al Salam Bank Bahrain	National Bank of Bahrain
	Liquidity Management Center Bahrain	Ahli United Bank
	Citi Islamic Investment Bank	Al Ahli Bank of Kuwait
	ABC Islamic Bank	Burgan Bank
	ARCAPITA Bank	
	Bahrain Islamic Bank	
	Bank AlKhair	
	Kuwait Finance House Bahrain	
	Al Baraka Islamic Bank	
	Investors Bank	
Bangladesh	Social Islami Bank	
	Islami Bank Bangladesh	
Egypt	Al Baraka Bank Egypt	
	Faisal Islamic Bank	
Indonesia	Bank Muamalat Indonesia	ArthaGraha
	Bank SyariahMandiri	Bank of Central Asia
		CIMB Niaga
		Bank Danamon
		Bank Internasional Indonesia
		Bank Mayapada
		Bank Mega
		Bank Nusantara Parahyangan
		Bank OCBC
		Bank PAN Indonesia
		Bank Permata
		Bank Pundi
		Bank Sudawesi
Iran	Bank Tejarat	
	Karafarin Bank	
	Saman Bank	
	Bank Sepah	
	Bank Saderat	
	Export Development Bank Iran	
	EghtesadNovin Bank	
Jordan	Islamic International Arab Bank	
	Jordon Islamic Bank	
Kuwait	Gulf Investment House	Commercial Bank of Kuwait
	Kuwait Finance House	Gulf Bank of Kuwait
		ABC Bank
		Kuwait International Bank
		National Bank of Kuwait
Malaysia	Al Rajhi Bank Malaysia	CIMB
	Kuwait Finance House Malaysia	Hong Leong
	Bank Rakyat	Maybank
	Bank Muamalat	Public Bank
	Bank Islam Malaysia Berhad	
Oman		Ahli Bank Muscat
		Bank of Dhofar
		Bank of Muscat
		HSBC Oman
		National Bank of Oman
Pakistan	Bank Islami Pakistan Limited	Bank Al Habib
	Meezan Islamic Bank	Bank Al Faysal
	Faysal Bank	Bank Al Habib Metropolitan
		MCB Bank
		Soneri Bank
		Bank of Punjab
		National Bank of Pakistan
Qatar	Qatar Islamic Bank	Arab Bank of Amman
	First Finance Company	Commercial Bank of Qatar
	Qatar International Islamic Bank	Doha Bank
		Qatar National Bank
Saudi Arabia	Bank Al Jazira	Arab National Bank
	Bank Al Bilad	Banque Saudi Fransi
	Al Rajhi Banking & Investment	Riyadh Bank

TABLE A1 (Continued)

Country	Islamic banks	Conventional banks
		Samba Financial Group
		Saudi British Bank
		Saudi Hollandi Bank
		Saudi Investment Bank
Sudan	Al Shamal Islamic Bank	
	Saudi Sudanese Bank	
	Al Salam Bank Sudan	
	Sudanese Islamic Bank	
	Savings & Social Development Bank	
	Animal Resources Bank	
	Financial Investment Bank	
	Blue Nile Mashreq Bank	
	Sudanese French Bank	
	Omdurman National Bank	
	Export Development Bank	
	Islamic Cooperative Development	
	Tadamon Islamic Bank Sudan	
	Al Baraka Bank Sudan	
	Bank of Khartoum	
	Faisal Islamic Bank	
Turkey	Bank Asya	Alternatif Bank
	Al Baraka Turk Participation Bank	Akbank
	Kuwait Turk Participation Bank	Sekerbank
		Tekstil Bankasi
		Turk Ekonomi Bankasi
		Turkiye Garanti Bankasi
		Turkiye Is Bankasi
		Yapive Kredi Bankasi
		Turkiye Sinai Kalkinma Bankasi
UAE	Sharjah Islamic Bank	Abu Dhabi Commercial Bank
	Dubai Islamic Bank	Commercial Bank International
	Emirates Islamic Bank	Commercial Bank of Dubai
	Abu Dhabi Islamic Bank	First Gulf Bank
		Gulf Finance House
		National Bank of Abu Dhabi
		National Bank of Fujairah
		Union National Bank
		United Arab Bank
Yemen	Islamic Bank of Yemen	
	Shamil Bank of Yeman & Bahrain	
	Saba Islamic Bank	
	Thadamon International Islamic	

(Continues)

TABLE A2 Data definitions and sources of variables

Acronym	Definition and measurement	Source
liquidity	Deposit/total Loan	Bloomberg/IRTI
size	Log of total assets	Bloomberg/IRTI
lg	Loan growth	Bloomberg/IRTI
demo	Institutionalized democracy (0 to 10)	Polity IV Database
autoc	Institutionalized autocracy (0 to10)	Polity IV Database
polity2	Subtraction of autoc score to demo score resulting in a unified polity scale ranging from +10 for strongly democratic and −10 for strongly autocratic	Polity IV Database
durable		Polity IV Database
xrreg	The extent of institutionalization of executive transfers (1 = unregulated; 4 = regulated)	Polity IV Database
xrcomp	The competitiveness of executive selection (1 = selection; 4 = competitions)	Polity IV Database

(Continues)

TABLE A2 (Continued)

Acronym	Definition and measurement	Source
	Rule of law (Percentile rank 0 = lowest to 100 = highest)	
va	Voice and accountability (Percentile rank 0 = lowest to 100 = highest)	WGI
ten	Regime durability. The number of years since the last regime change or number of ruling years. 0 is the baseline year	WGI
g_stab	Government stability (0–12; re-indexed to ensure consistency of interpretation)	International Country Risk Guide (ICRG), The PRS Group
soc	Socioeconomic condition (0–12; re-indexed)	ICRG, PRS
int	Internal conflict (0–12; re-indexed)	ICRG, PRS
cor2	Corruption (0–6; re-indexed)	ICRG, PRS
dem_acc	Democratic accountability (0–6; re-indexed)	ICRG, PRS
lao	Law and order (0–6; re-indexed)	ICRG, PRS
pr	Political rights (0 = highest rights; 7 = lowest rights)	Freedom House
cl	Civil liberties (0 = highest rights; 7 = lowest rights)	Freedom House
a	Electoral process (0 = no election; 15 = vote freely in legitimate elections)	Freedom House
b	Political pluralism and participation (0 = no political pluralism; 15 = participate freely in political process)	Freedom House
c	Functioning of the government (0 = no representative; 15 = have representative that are accountable to them)	Freedom House
d	Freedom of expression & belief (0 = no freedom; 15 = exercise freedom of expression & belief)	Freedom House
e	Associational and organizational rights (0 = not free; 15 = able to freely assemble and associate)	Freedom House

TABLE A2 (Continued)

Acronym	Definition and measurement	Source
xropen	The openness of executive recruitment (1 = closed; 4 = open)	Polity IV Database
xconst	Executive constraint (1 = unlimited executive authority; 5 = substantial limitation)	Polity IV Database
parreg	Regulation of participation (1 = unregulated; 5 = regulated). Measures the degree of organization and institutionalization of participation	Polity IV Database
parcomp	Competitiveness of participation (1 = repressed; 5 = competitive). Measures the degree to which political participation is free from government control	Polity IV Database
exrec	Executive recruitment	Polity IV Database
exconst	Executive constraint (1 = no regular limitations on executive actions; 5 = substation limitation)	Polity IV Database
polcomp	Political competition (1 = uncompetitive; 5 = competitive)	Polity IV Database
elec	Year of election	Database of Political Institutions, World Bank (DPI)
b_elec	Year before election	DPI
p_elec	Year after election	DPI
cor	Control of corruption (Percentile rank 0 = lowest to 100 = highest)	Worldwide Governance Index, World Bank (WGI)
g_eff	Government effectiveness (Percentile rank 0 = lowest to 100 = highest)	WGI
p_stab	Political stability & absence of violence/terrorism (Percentile rank 0 = lowest to 100 = highest)	WGI
reg	Regulatory quality (Percentile rank 0 = lowest to 100 = highest)	WGI
rol		WGI

TABLE A2 (Continued)

Acronym	Definition and measurement	Source
f	Rule of law (0 = no access; 15 = access to an established and equitable system of rule of law)	Freedom House
g	Personal autonomy and individual rights (0 = no freedom; 15 = enjoy social and economic freedoms, including equal access to economic opportunities and the right to hold private property)	Freedom House

TABLE A3 Correlation matrix

	lg	ta	dta	polity2	demo	auto	pr	cl	cor	g_eff	p_stab
lg	1.0000										
ta	−0.0133	1.0000									
dta	0.0025	−0.3899	1.0000								
polity2	0.0735	−0.3045	0.0966	1.0000							
demo	0.0400	0.6233	−0.3826	0.2809	1.0000						
auto	−0.0303	0.7558	−0.3936	−0.6340	0.5633	1.0000					
pr	−0.0811	−0.1501	0.2165	−0.6715	−0.7344	−0.0226	1.0000				
cl	−0.0776	0.0031	0.1714	−0.6195	−0.5969	0.0415	0.9045	1.0000			
cor	−0.0184	−0.5611	0.1539	−0.0055	−0.4539	−0.3424	0.0651	−0.1428	1.0000		
g_eff	−0.0025	−0.4691	0.0897	0.1764	−0.1935	−0.2913	−0.1631	−0.3778	0.8838	1.0000	
p_stab	−0.0153	−0.5568	0.1684	−0.0098	−0.5066	−0.3817	0.0926	−0.1237	0.9156	0.8551	1.0000
reg	−0.0003	−0.5536	0.1348	0.2043	−0.2343	−0.3472	−0.1579	−0.3594	0.8607	0.8914	0.8038
rol	−0.0195	−0.5841	0.1589	0.0807	−0.3687	−0.3491	−0.0302	−0.2410	0.9163	0.8992	0.8970
va	0.0650	−0.0608	−0.2073	0.6171	0.5418	−0.0815	−0.8928	−0.9145	0.2710	0.4615	0.2364
ten	−0.0269	0.2295	−0.1559	−0.3386	0.2633	0.5174	−0.1015	−0.1573	0.2651	0.2791	0.2393
g_stab	0.0191	−0.2669	0.2053	−0.2483	−0.4021	−0.1050	0.3497	0.2302	0.3443	0.1959	0.4053
soci	0.0033	−0.4902	0.1656	0.0547	−0.3667	−0.3333	−0.0093	−0.2018	0.7543	0.7612	0.7821
cor2	−0.0005	−0.1094	0.0162	0.1403	0.0939	−0.0321	−0.3420	−0.4336	0.5349	0.6085	0.5118
lao	0.0412	−0.7073	0.2641	0.2135	−0.4275	−0.5107	−0.0494	−0.1788	0.6865	0.6167	0.6456
dem_acc	0.0369	−0.1049	0.1673	0.1682	0.0128	−0.1238	−0.3132	−0.3103	0.3432	0.3291	0.3259
int_con	0.0120	−0.4031	0.1602	0.0213	−0.2876	−0.2383	−0.0268	−0.1709	0.6644	0.6799	0.7715

	reg	rol	va	ten	g_stab	soci	cor2	lao	dem_acc	int_con
lg										
ta										
dta										
polity2										
demo										
auto										

(Continues)

TABLE A3 (Continued)

	reg	rol	va	ten	g_stab	soci	cor2	lao	dem_acc	int_con
pr										
cl										
cor										
g_eff										
p_stab										
reg	1.0000									
rol	0.9281	1.0000								
va	0.4473	0.3402	1.0000							
ten	0.3307	0.3449	0.1648	1.0000						
g_stab	0.2654	0.2650	−0.1585	0.1939	1.0000					
soci	0.7358	0.8090	0.2392	0.2532	0.2144	1.0000				
cor2	0.6526	0.6211	0.4527	0.4636	0.0447	0.6278	1.0000			
lao	0.7687	0.7539	0.2349	0.1960	0.2139	0.6701	0.5166	1.0000		
dem_acc	0.3122	0.3514	0.3328	0.2218	0.0590	0.3660	0.4289	0.3829	1.0000	
int_con	0.6340	0.7227	0.2429	0.2609	0.3924	0.7528	0.4722	0.5166	0.3673	1.0000

TABLE A4 Panel unit root diagnostics—At level

Variable	t_{HS}	t_{DH}
lg	−2.312 (0.000)	−1.437 (0.000)
ta	−4.2322 (0.000)	−2.749 (0.9590)
dtl	−3.856 (0.000)	−3.213 (0.000)
polity2	−1.9093 (0.0281)	−3.433 (0.099)
demo	−2.8029 (0.003)	−2.543 (0.000)
auto	−4.011 (0.000)	−3.997 (0.000)
pr	−1.949 (0.005)	−1.87 (0.005)
cl	−4.737 (0.000)	−2.739 (0.003)
cor	−4.441 (0.000)	−4.102 (0.000)
g_eff	−2.398 (0.002)	−2.563 (0.000)
p_stab	−3.997 (0.000)	−3.419 (0.000)
reg	−1.985 (0.000)	−2.114 (0.001)
rol	−2.111 (0.000)	−2.148 (0.010)
va	−2.3444 (0.000)	−2.144 (0.000)
ten	−1.222 (0.000)	−1.401 (0.000)
g_stab	−1.668 (0.000)	−1.592 (0.000)
socio	−3.423 (0.000)	−3.769 (0.000)
int_con	−2.321 (0.000)	−2.008 (0.000)
cor2	−3.533 (0.000)	−2.996 (0.000)
dem_acc	−3.713 (0.000)	−3.559 (0.000)
lao	−2.573 (0.000)	−2.237 (0.002)

Note: t_{HS} and t_{DH} represent Herwartz and Siedenburg (2008) and Demetrescu and Hanck (2012) tests, respectively.